

## 4(c)(8)—Agency Transactional Services (Futures Commission Merchants and Futures Brokerage) Section 3250.0

A futures commission merchant (FCM) is an entity referred to in the Commodity Exchange Act to denote a registered firm that is in the business of soliciting or accepting orders, as broker, for the purchase or sale of any exchange-traded futures contract and options thereon. For the purposes of this examiner guidance, the term “FCM activities” is used in a broad context and refers to all futures brokerage activities, operations, and their associated risks that are subject to the Federal Reserve System’s supervision (see SR-97-33). In connection with these activities, banking organizations may hold customer funds, assets, or property and may be members of futures exchanges and their associated clearinghouses. They may also offer related advisory services as registered commodity trading advisers (CTAs). The guidance addresses the expanding scope of futures activities conducted by different types of banking organizations worldwide, and implements supervisory initiatives to effect more risk-focused and burden-sensitive approaches to the supervision of FCM activities. The guidance is designed to assist examiners in assessing how well a consolidated financial organization manages one or more discrete futures brokerage operations, as well as in making a broader assessment of the organization’s overall risk management.

The guidance pertains to FCM subsidiaries of bank holding companies (BHCs), but it is also applicable to FCM subsidiaries of state member banks, Edge Act corporations, and foreign banking organizations. It addresses the broader scope of permissible futures brokerage activities articulated within Regulation Y,<sup>1</sup> and by exten-

sion in Regulation K, and focuses on the adequacy of management and the management processes used to control the credit, market, liquidity, reputation, and operations risks entailed in these activities, including brokerage, clearing, funds management, and advisory services.

The guidance takes a global line-of-business supervisory approach to the inspection of FCM activities rather than the traditional full-scope inspections of individual FCM subsidiaries, many of which are primarily supervised by functional regulators. Reviews and reports of functional regulators should be used to the fullest extent when planning and conducting inspections of FCM activities of bank holding companies and other banking organizations to avoid duplication and minimize supervisory burdens. However, in conducting an inspection of various aspects of an FCM’s activities, a review of various functions, derived from a sample of the organization’s FCM subsidiaries, may be necessary and appropriate to determine the extent of the risks these operations pose to the banking organization and to determine whether management of those risks is satisfactory. The examiner should pay particular attention to activities conducted in FCM subsidiaries that have not been subject to a regular inspection by their functional regulator and to FCM activities of foreign affiliates in which there is uncertainty concerning the level of local supervision.

BHC subsidiaries, banks (generally through operating subsidiaries), Edge Act corporations, and foreign banking organizations (FBOs) operating in the United States may operate futures brokerage and clearing services involving a myriad of financial and nonfinancial futures contracts and options on futures. These activities can involve futures exchanges and clearinghouses throughout the world. In general, most organizations conduct these activities as FCMs.

The Federal Reserve has a supervisory interest in ensuring that the banking organizations subject to its oversight conduct their futures brokerage activities in a safe and sound manner consistent with Regulations Y and K (including any terms and conditions in Board orders for a particular organization). Accordingly, a review of futures brokerage activities is an important

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1. The Board broadened the scope of permissible FCM nonbanking activities for a bank holding company with the revision of Regulation Y, effective April 21, 1997. For example, the following activities are permissible:

- Derivative contracts can be executed and cleared on a broad range of nonfinancial commodities.
- Derivative contracts can be cleared without simultaneously providing execution services. Likewise, execution services can be provided without also providing clearing services.
- Foreign-exchange transactional services can be provided in the same FCM subsidiary that provides advice regarding foreign exchange.
- Bank holding companies can engage in FCM activities through a section 20 subsidiary.
- An FCM nonbanking subsidiary can trade for its own account.
- An FCM nonbanking subsidiary may act on exchange-traded futures contracts and on options on futures contracts based on a financial or nonfinancial commodity.
- A bank holding company may combine FCM activities and incidental activities. For example, FCM activities may be combined with futures-related financing to customers, such

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as financing to cover margin obligations (note: such financing may be prohibited by some exchanges).

element for inspections of BHCs, examinations of state member banks, and reviews of FBO operations. The following guidance on evaluating the futures brokerage activities of bank holding company subsidiaries, branches and agencies of foreign banks operating in the United States, or any operating subsidiaries of state member banks provides a list of procedures that may be used to tailor the scope of an inspection of these activities.

### 3250.0.1 SCOPE OF GUIDANCE

Examiners are to use a risk-based inspection approach to evaluating FCM activities—including brokerage, clearing, funds management, and advisory activities. Significant emphasis should be placed on evaluating the adequacy of management and the management processes used to control the credit, market, liquidity, legal, reputation, and operations risks entailed in these operations. Both the adequacy of risk management and the quantitative level of risk exposures should be assessed as appropriate to the scope of the FCM's activities. The objectives of a particular inspection should dictate the FCM activities to be reviewed and set the scope of the inspection.

Examiners are to use a functional-regulatory approach to minimize duplicative inspection and supervisory burdens. Reviews and reports of functional regulators should be used to their fullest extent. However, absent recent oversight inspection, or if an examiner believes that particular facts and circumstances at the banking organization or in the marketplace deem it necessary, a review of operations that would normally be assessed by the appropriate commodities regulator may be appropriate (such as a review of front- or back-office operations).

When futures brokerage occurs in more than one domestic or foreign affiliate, examiners should assess the adequacy of the management of the futures brokerage activities of the consolidated financial organization to ensure that the parent organization recognizes and effectively manages the risks posed by its various futures brokerage subsidiaries. Accordingly, in reviewing futures brokerage operations, examiners should identify all bank holding company, bank operating, or FBO subsidiaries that engage in FCM activities and the scope of those activities. Not all subsidiaries may need to be reviewed to assess the risk management of the consolidated

organization. Selection of the particular FCM subsidiaries to be reviewed should be based on an assessment of the risks posed by their activities to the consolidated organization.

This guidance primarily addresses the assessment of activities associated with futures brokerage operations. Any proprietary trading that occurs at an FCM should be assessed in connection with the review of proprietary trading activities of the consolidated financial organization, using the appropriate guidance in the Federal Reserve's *Trading and Capital-Markets Activities Manual*. Similarly, when a review of futures advisory activities is planned, examiners should refer to investment, financial, and futures advisory inspection guidance in this manual (sections 3130.0 and 3130.4) and the *Trust Examination Manual* as appropriate.

### 3250.0.2 EVALUATION OF FCM RISK MANAGEMENT

Consistent with existing Federal Reserve policies, examiners should evaluate the risk-management practices of FCM operations and ensure that this evaluation is incorporated appropriately in the rating of risk management under the bank (CAMELS), BHC (BOPEC), and FBO (ROCA) rating systems. Accordingly, examiners should place primary consideration on findings related to the adequacy of (1) board and senior management oversight; (2) policies, procedures, and limits used to control risks; (3) systems for measuring, monitoring, and reporting risk; and (4) internal controls and audit programs.

#### 3250.0.2.1 Board and Senior Management Oversight

The board of directors has the ultimate responsibility for the level of risks taken by the organization. Accordingly, the board, a designated subcommittee of the board, or a high level of senior management should approve overall business strategies and significant policies that govern risk-taking in the organization's FCM activities. In particular, the board or a committee thereof should approve policies that identify authorized activities and managerial oversight, and articulate risk tolerances and exposure limits of FCM activities. The board should also actively monitor the performance and risk profile of its FCM activities. Directors and senior management should periodically review information that is sufficiently detailed and timely to allow them to understand and assess the various risks involved in these activities. In addition, the board or a

delegated committee should periodically reevaluate the business strategies and major risk-management policies and procedures, emphasizing the organization's financial objectives and risk tolerances.

The FCM's senior management is responsible for ensuring that policies and procedures for conducting FCM activities on both a long-range and day-to-day basis are adequate. Senior management or a designated subcommittee of the board should review and approve these policies and procedures annually. The consistency of these policies with parent company limits or other directions pertaining to the FCM's activities should be confirmed. Management must also maintain (1) clear lines of authority and responsibility for managing operations and the risks involved, (2) appropriate limits on risk-taking, (3) adequate systems and standards for measuring and tracking risk exposures and measuring financial performance, (4) effective internal controls, and (5) a comprehensive risk-reporting and risk-management review process. To provide adequate oversight, management should fully understand the risk profile of FCM activities. Examiners should review reports given to senior management and evaluate whether they consist of good summary information and sufficient detail that will enable management to assess and manage the FCM's risk. As part of its oversight responsibilities, senior management should periodically review the organization's risk-management procedures to ensure that they remain appropriate and sound.

Management should also ensure that activities are conducted by competent staff whose technical knowledge and experience are consistent with the nature and scope of the organization's activities. There should be sufficient depth in staff resources to manage these activities if key personnel are not available. Management should also ensure that back-office and financial-control resources are sufficient to effectively manage and control risks. Functions for measuring, monitoring, and controlling risk should have clearly defined duties. There should be adequate separation of duties in key elements of the risk-management process to avoid potential conflicts of interest. The nature and scope of these safeguards should be in accordance with the scope of the FCM's activities.

#### 3250.0.2.2 Policies, Procedures, and Limits

FCMs should maintain written policies and procedures that clearly outline their approach for

managing futures brokerage and related activities. Such policies should be consistent with the organization's broader business strategies, capital adequacy, technical expertise, and general willingness to take risk. Policies, procedures, and limits should address the relevant credit, market, liquidity, reputation, and operations risks in light of the scope and complexity of the FCM's activities. Policies and procedures should establish a logical framework for limiting the various risks involved in an FCM's activities and should clearly delineate lines of responsibility and authority over these activities. They should also address the approval of new product lines, strategies, and other activities; conflicts of interest including transactions by employees; and compliance with all applicable legal requirements. Procedures should incorporate and implement the parent company's relevant policies and should be consistent with applicable statutes, Federal Reserve Board regulations, interpretations, Board orders, and supervisory policies and guidance.

A sound system of integrated limits and risk-taking guidelines is an essential component of the risk-management process. Such a system should set boundaries for organizational risk-taking and ensure that positions that exceed certain predetermined levels receive prompt management attention, so they can be either reduced or prudently addressed.

#### 3250.0.2.3 Risk Measurement, Monitoring, and Reporting

An FCM's system for measuring the credit, market, liquidity, and other risks involved in its activities should be as comprehensive and accurate as practicable and should be commensurate with the nature of its activities. Risk exposures should be aggregated across customers, products, and activities to the fullest extent possible. Examiners should evaluate whether the risk measures and the risk-measurement process are sufficiently robust to accurately reflect the different types of risks facing the organization. Clear standards for measuring risk exposures and financial performance should be established. The standards should provide a common framework for limiting and monitoring risks and should be understood by all relevant personnel.

An accurate, informative, and timely management information system is essential to the prudent operation of an FCM. Accordingly, the

examiner's assessment of the quality of the management information system is an important factor in the overall evaluation of the risk-management process. Appropriate mechanisms should exist for reporting risk exposures and the financial performance of the FCM to its board and parent company, as well as for internal management purposes. FCMs must establish management reporting policies to apprise their boards of directors and senior management of material developments, the adequacy of risk management, operating and financial performance, and material deficiencies identified during reviews by regulators and by internal or external audits. The FCM should also provide reports to the parent company (or in the case of foreign-owned FCMs, to its U.S. parent organization, if any) of financial performance; adherence to risk parameters and other limits and controls established by the parent for the FCM; and any material developments, including findings of material deficiencies by regulators. Examiners should determine the adequacy of an FCM's monitoring and reporting of its risk exposure and financial performance to appropriate levels of senior management and to the board of directors.

#### 3250.0.2.4 Internal Controls

An FCM's internal control structure is critical to its safe and sound functioning in general and to its risk-management system, in particular. Establishing and maintaining an effective system of controls, including the enforcement of official lines of authority and appropriate separation of duties—such as trading, custodial, and back-office—is one of management's more important responsibilities. Appropriately segregating duties is a fundamental and essential element of a sound risk-management and internal control system. Failure to implement and maintain an adequate separation of duties can constitute an unsafe and unsound practice, possibly leading to serious losses or otherwise compromising the financial integrity of the FCM.

When properly structured, a system of internal controls promotes effective operations and reliable financial and regulatory reporting; safeguards assets; and helps to ensure compliance with relevant laws, regulations, and organizational policies. Ideally, internal controls are tested by an independent internal auditor who reports directly to either the entity's board of

directors or its designated committee. Personnel who perform these reviews should generally be independent of the function they are assigned to review. Given the importance of appropriate internal controls to banking organizations of all sizes and risk profiles, the results of audits or reviews, whether conducted by an internal auditor or by other personnel, should be adequately documented, as should management's responses to them. In addition, communication channels should exist that will allow negative or sensitive findings to be reported directly to the board of directors or the relevant board committee (for example, a board audit committee).

#### 3250.0.3 FUTURES EXCHANGES, CLEARINGHOUSES, AND FCMs

Futures exchanges provide auction markets for standardized futures and options on futures contracts. In the United States and most other countries, futures exchanges and FCMs are regulated by a governmental agency. Futures exchanges are membership organizations and impose financial and other regulatory requirements on members, particularly those that do business for customers as brokers. In the United States and most other countries, futures exchanges also have quasi-governmental (self-regulatory) responsibilities to monitor trading and prevent fraud, with the authority to discipline or sanction members that violate exchange rules. FCMs may be members of the exchange on which they effect customers' trades. When they are not members, FCMs must use other firms who are exchange members to execute customer trades.<sup>2</sup>

Each futures exchange has an affiliated clearinghouse responsible for clearing and settling trades on the exchange and for managing associated risks. When a clearinghouse accepts transaction information from its clearing members, it generally guarantees the performance of the transaction to each member and becomes the counterparty to the trade (that is, the buyer to every seller and the seller to every buyer). Daily cash settlements are paid or collected by clearing members through the clearinghouse. The cash transfers represent the difference between the original trade price and the daily official closing settlement price for each commodity futures contract. The two members settle their sides of the transaction with the clearinghouse,

2. A firm or trading company that maintains only a proprietary business may become a member of an exchange without registering as an FCM.

usually by closing out the position before delivery of the futures contract or the expiration of the option on the futures contract.

An exchange member that wishes to clear or settle transactions for itself, customers, other FCMs, or commodity professionals (locals or market makers) may become a member of the affiliated clearinghouse (clearing member) if it is able to meet the clearinghouse's financial-eligibility requirements. In general, these requirements are more stringent than those required for exchange membership. For example, a clearing member usually is required to maintain a specified amount of net capital in excess of the regulatory required minimum and to make a guaranty deposit as part of the financial safeguards of the clearinghouse. The size of the deposit is related to the scale of the clearing member's activity. If it is not a member of the clearinghouse for the exchange on which a contract is executed, an FCM must arrange for another FCM that is a clearing member to clear and settle its transactions.<sup>3</sup>

Margin requirements are an important risk-management tool for maintaining the financial integrity of clearinghouses and their affiliated exchanges. Clearinghouses require that their members post initial margin (performance bond) on a new position to cover potential credit exposures borne by the clearinghouse. The clearing firm, in turn, requires its customers to post margin. At the end of each day, and on some exchanges on an intraday basis, all positions are marked to the market. Clearing members with positions that have declined in value pay the amount of the decline in cash to the clearinghouse, which then pays the clearing members holding positions that have increased in value on that day. This process of transferring gains and losses among clearing-member firms, known as collecting variation margin, is intended to periodically eliminate credit-risk exposure from the clearinghouse.<sup>4</sup> In volatile markets, a clearinghouse may call for additional variation margin during the trading day, sometimes with only

one hour's notice, and failure to meet a variation (or initial) margin call is treated as a default to the clearinghouse.

Some clearinghouses also require that their members be prepared to pay loss-sharing assessments to cover losses sustained by the clearinghouse in meeting the settlement obligations of a clearing member that has defaulted on its (or its customers') obligations. Such assessments arise when losses exceed the resources of defaulting members, the guaranty fund, and other surplus funds of the clearinghouse. Each clearinghouse has its own unique loss-sharing rules.<sup>5</sup> At least one U.S. and one foreign exchange have unlimited loss-sharing requirements. Most U.S. clearinghouses relate loss-sharing requirements to the size of a member's business at the clearinghouse. Given the potential drain on a banking organization's financial resources, the exposure to loss-sharing agreements should be a significant consideration in the decision to become a clearing member. A parent bank holding company may not provide a guarantee or become liable to an exchange or clearing association other than for trades conducted by the subsidiary for its own account or for the account of any affiliate. (See section 225.28(b)(6)(iv) of Regulation Y.)

#### 3250.0.4 COMMODITY EXCHANGE ACT, COMMODITY FUTURES TRADING COMMISSION, AND SELF-REGULATORY ORGANIZATIONS

In the United States, the primary regulator of exchange-traded futures activities is the Commodity Futures Trading Commission (CFTC), which was created by and derives its authority from the Commodity Exchange Act (CEA). The CFTC has adopted registration,<sup>6</sup> financial responsibility, antifraud, disclosure, and other rules for FCMs and CTAs, and has general enforcement authority over commodities firms and professionals that buy or sell exchange-traded futures contracts.

5. Clearinghouses usually (1) retain the right to use assets owned by clearing members, but under the control of the clearinghouse (for example, proprietary margin); (2) require additional contributions of funds or assets or require the member to purchase additional shares of the clearinghouse; or (3) perfect a claim against the member for its share of the loss.

6. Many FCMs also are SEC-registered as broker-dealers and are subject to SEC and CFTC financial-responsibility rules.

3. The nonmember FCM opens an account, usually on an omnibus basis, with the clearing-member FCM. Separate omnibus accounts have to be maintained for customer and non-customer or proprietary trading activity. If the FCM does not carry customer accounts by holding customer funds and maintaining account records, the clearing member will carry the customer's account on a fully disclosed basis and issue confirmations, account statements, and margin calls directly to the customer on behalf of the introducing FCM. In such cases, the introducing FCM operates as an introducing broker (IB) and could have registered with the Commodity Futures Trading Commission as such.

4. Some foreign exchanges do not allow the withdrawal of unrealized profits as mark-to-market variation.

The futures exchanges, in addition to providing a marketplace for futures contracts, are deemed to be self-regulatory organizations (SROs) under the CEA. For example, a number of SROs have adopted detailed uniform practice rules for FCMs, including “know your customer” recordkeeping rules and other formal customer-disclosure requirements. The National Futures Association (NFA) also is an SRO, although it does not sponsor a futures exchange or other marketplace. The NFA has adopted sales-practice rules applicable to members who do business with customers. All FCMs that wish to accept orders and hold customer funds and assets must be members of the NFA.

The CEA and rules of the CFTC require the SROs to establish and maintain enforcement and surveillance programs for their markets and to oversee the financial responsibility of their members.<sup>7</sup> The CFTC has approved an arrangement under which a designated SRO (DSRO) is responsible for performing on-site audits and reviewing periodic reports of a member FCM that is a member of more than one futures exchange. The NFA is the DSRO for FCMs that are not members of any futures exchange.

Oversight of FCMs is accomplished through annual audits by the DSRO and the filing of periodic financial statements and early warning reports by FCMs, in compliance with CFTC and SRO rules. In summary, this oversight encompasses the following three elements:

1. *Full-scope audits at least once every other year of each FCM that carries customer accounts.* Audit procedures conform to a Uniform Audit Guide developed jointly by the SROs. The full-scope audit focuses on the firm’s net capital computations, segregation of customer funds and property, financial reporting, recordkeeping, and operations.<sup>8</sup> The audit also reviews sales practices (including customer records, disclosures,

advertisements, and customer complaints) and the adequacy of employee supervision. The audit’s scope should reflect the FCM’s prior compliance history as well as the examiner’s on-site evaluation of the firm’s internal controls. During the off-year, the DSROs perform limited-scope audits of member FCMs. This audit is limited to financial matters such as a review of the FCM’s net capital computations, segregation of customer funds, and its books and records.

2. *FCM quarterly financial reporting requirements.* FCMs are required to file quarterly financial statements (form 1-FR-FCM) with their DSROs. The fourth-quarter statement must be filed as of the close of the FCM’s fiscal year and must be certified by an independent public accountant. The filings generally include statements regarding changes in ownership equity, current financial condition, changes in liabilities subordinated to claims of general creditors, computation of minimum net capital, segregation requirements and funds segregated for customers, secured amounts and funds held in separate accounts, and any other material information relevant to the firm’s financial condition. The certified year-end financial report also must contain statements of income and cash flows.
3. *Early warning reports.* FCMs are required to notify the CFTC and the SROs when certain financial weaknesses are experienced.<sup>9</sup> For example, if an FCM’s net capital falls to a specified warning level, it must file a written notice within five business days and file monthly financial reports (form 1-FR-FCM) until its net capital meets or exceeds the warning level for a full three months. If an FCM’s net capital falls below the minimum required, it must cease doing business and give telegraphic notice to the CFTC and any commodities or securities SRO of which it is a member. Similar notices must be given by a clearing organization or carrying FCM when it determines that a position of an FCM must be liquidated for failure to meet a margin call or other required deposit.

## 3250.0.5 FEDERAL RESERVE REGULATION OF FCMs AND CTAs

Bank holding companies are permitted, under Regulation Y (section 225.28(b)(7)(iv)), to engage

7. CFTC Rule 1.51, contract market program for enforcement, requires that SROs monitor market activity and trading practices in their respective markets, perform on-site examinations (audits) of members’ books and records, review periodic financial reports filed by members, and bring disciplinary and corrective actions against members for violations of the CEA and CFTC and SRO rules.

8. If an FCM is also a broker-dealer, the DSRO is not required to examine the FCM for compliance with net capital requirements if the DSRO confers with the broker-dealer’s examining authority at least annually to determine that the FCM is in compliance with the broker-dealer’s net capital requirements and receives the DSRO copies of all examinations.

9. CFTC Rule 1.12 requires the maintenance of minimum financial requirements by FCMs and introducing brokers. These requirements are similar to those applicable to broker-dealers under SEC rules.

in FCM and CTA activities on both domestic and foreign futures exchanges through separately incorporated nonbank subsidiaries. As a general matter, the nonbank subsidiaries of bank holding companies (and some foreign banks) provide services to unaffiliated customers in the United States under section 4(c)(8) of the Bank Holding Company Act (BHC Act) and to unaffiliated customers outside the United States under Regulation K.<sup>10</sup> Banks and the operating subsidiaries of banks usually provide futures-related services to unaffiliated parties in the United States under the general powers of the bank and to unaffiliated parties outside the United States under Regulation K. These various subsidiaries may provide services to affiliates under section 4(c)(1)(C) of the BHC Act.

Regulation Y permits a bank holding company subsidiary that acts as an FCM to engage in other activities in the subsidiary, including futures advisory services and trading, as well as other permissible securities and derivative activities as defined in sections 225.28(b)(6) (financial and investment advisory activities) and 225.28(b)(7) (agency transactional services for customer investments). Section 225.28(b)(7) specifically authorizes FCMs to provide agency services for unaffiliated persons in execution, clearance, or execution and clearance of any futures contract and option on a futures contract traded on an exchange in the United States and abroad. It also includes the authority to engage in other agency-type transactions (for example, riskless principal) involving a forward contract, an option, a future, an option on a future, and similar instruments. Furthermore, this section codifies the long-standing prohibition against a parent bank holding company's issuing any guarantees or otherwise becoming liable to an exchange or clearinghouse for transactions effected through an FCM, except for the proprietary trades of the FCM and those of affiliates.

A well-capitalized and well-managed bank holding company, as defined in section 225.2(r) and (s) of Regulation Y, respectively, may commence activities as an FCM or a CTA by filing a notice prescribed under section 225.23(a) of Regulation Y. Bank holding companies that are not eligible to file notices or that wish to act in a

capacity other than as an FCM or CTA, such as a commodity pool operator (CPO), must follow the specific application process for these activities. Examiners should ensure that all of these activities are conducted in accordance with the Board's approval order.

A bank holding company, bank, or FBO parent company of an FCM is expected to establish specific risk parameters and other limits and controls on the brokerage operation. These limits and controls should be designed to manage financial risk to the consolidated organization and should be consistent with its business objectives and overall willingness to assume risk.

### 3250.0.6 PARTICIPATION IN FOREIGN MARKETS

FCMs frequently transact business on foreign exchanges as either exchange or clearinghouse members or through third-party brokers that are members of the foreign exchange. The risks of doing business in foreign markets generally parallel those in U.S. markets; however, some unique issues of doing business on foreign futures exchanges must be addressed by the FCM and its parent company to ensure that the activity does not pose undue risks to the consolidated financial organization.

Before doing business on a foreign exchange, an FCM should understand the legal and operational differences between the foreign exchange and U.S. exchanges. For example, the FCM should know about local business practices and legal precedents that pertain to business in the foreign market. In addition, the FCM should know how the foreign exchange is regulated and how it manages risk, and should develop policies and the appropriate operational infrastructure of controls, procedures, and personnel to manage these risks. Accordingly, examiners should confirm that, in considering whether and how to participate in a foreign market, an FCM performs due diligence on relevant legal and regulatory issues, as well as on local business practices. Foreign-exchange risks should be understood and authorized by the FCM's parent company, and any limits set by the parent company or FCM management should be carefully monitored. The FCM and its parent company also should assess the regulatory and financial risks associated with exchange and clearinghouse membership in a foreign market, including an understanding of the extent to which the

10. Those nonbank subsidiaries that operate in the United States may open offices outside the United States if (1) the bank holding company's authority under Regulation Y is not limited geographically, (2) the foreign office is not a separately incorporated entity, and (3) the activities conducted by the foreign office are within the scope of the bank holding company's authority under Regulation Y. In addition, a bank holding company may operate a limited foreign-based business in the United States under Regulation K.

foreign clearinghouse monitors and controls day-to-day credit risk and its loss-sharing requirements.

### 3250.0.7 SPECIFIC RISKS AND THEIR RISK-MANAGEMENT CONSIDERATIONS

In general, FCMs face five basic categories of risk—credit risk, market risk, liquidity risk, reputation risk, and operations risk. The following discussions highlight specific considerations in evaluating the key elements of sound risk management as they relate to these risks. The compliance and internal controls functions provide the foundation for managing the risks of an FCM.

#### 3250.0.7.1 Credit Risk

FCMs encounter a number of different types of credit risks. The following discussions identify some of these risks and discuss sound risk-management practices applicable to each.

##### 3250.0.7.1.1 Customer-Credit Risk

Customer-credit risk is the potential that a customer will fail to meet its variation margin calls or its payment or delivery obligations. An FCM should establish a credit-review process for new customers that is independent of the marketing and sales function. It is not unusual for the FCM's parent company (or banking affiliate) to perform the credit evaluation and provide the necessary internal approvals for the FCM to execute and clear futures contracts for particular customers. In some situations, however, the FCM may have the authority to perform the credit review internally. Examiners should determine how customers are approved and confirm that documentation in the customer's credit files is adequate even when the approval is performed by the parent. Customer-credit files should indicate the scope of the credit review and contain approval of the customer's account and credit limits. For example, customer-credit files may contain recent financial statements, sources of liquidity, trading objectives, and any other pertinent information used to support the credit limits established for the customer. In addition,

customer-credit files should be updated periodically.

FCM procedures should describe how customer-credit exposures will be identified and controlled. For example, an FCM could monitor a customer's transactions, margin settlements, or open positions as a means of managing the customer's credit risk. Moreover, procedures should be in place to handle situations in which the customer has exceeded credit limits. These procedures should give senior managers who are independent of the sales and marketing function the authority to approve limit exceptions and require that such exceptions be documented.

##### 3250.0.7.1.2 Customer-Financing Risk

Several exchanges, particularly in New York and overseas, allow FCMs to finance customer positions. These exchanges allow an FCM to lend initial and variation margin to customers subject to taking the capital charges under the CFTC's (or SEC's) capital rules if the charges are not repaid within three business days. In addition, some exchanges allow FCMs to finance customer deliveries, again subject to a capital charge.

An FCM providing customer-financing services should adopt financing policies and procedures that identify customer-credit standards. The financing policies should be approved by the parent company and should be consistent with the FCM's risk tolerance. In addition, an FCM should establish overall lending limits for each customer based on a credit review that is analogous to that performed by a bank with similar lending services. The process should be independent of the FCM's marketing, sales, and financing functions, but it may be performed by the FCM's banking affiliate. Examiners should determine how customer-financing decisions are made and confirm that documentation is adequate, even when an affiliate approves the financing. In addition, the FCM should review financial information on its customers periodically and adjust lending limits when appropriate.

##### 3250.0.7.1.3 Clearing-Only Risk

FCMs often enter into agreements to clear, but not execute, trades for customers. Under a "clearing-only" arrangement, the customer gives its order directly to an executing FCM. The executing FCM then gives the executed transaction to the clearing FCM, which is responsible for accepting and settling the transaction. Cus-

tomers often prefer this arrangement because it provides the benefits of centralized clearing (recordkeeping and margin payments) with the flexibility of using a number of specialized brokers to execute transactions.

FCMs entering into clearing-only arrangements execute written give-up agreements, which are triparty contracts that set forth the responsibilities of the clearing FCM, the executing FCM, and the customer. Most FCMs use the “uniform give-up agreement” prepared by the Futures Industry Association, although some FCMs still use their own give-up contracts. The uniform give-up agreement permits a clearing FCM, upon giving prior notice to the customer and the executing FCM, to place limits or conditions on the transactions it will accept to clear or terminate the arrangement. If an executed transaction exceeds specified limits, the FCM may decline to clear the transaction unless it is acting as the qualifying or primary clearing FCM for the customer and has not given prior notice of termination.

Clearing-only arrangements can present significant credit risks for an FCM. An FCM’s risk-management policies and procedures for clearing-only activities should address the qualifications required of clearing-only customers and their volume of trading, the extent to which customer-trading activities can be monitored by the clearing-FCM at particular exchanges, and how aggregate risk will be measured and managed.

The FCM should establish trading limits for each of its clearing-only customers and have procedures in place to monitor their intraday trading exposures. The FCM should take appropriate action to limit its liability either by reviewing and approving a limit exception or by rejecting the trade if a clearing-only customer has exceeded acceptable trading limits. Examiners should confirm that the FCM formally advises (usually in the give-up agreement) its customers and their executing FCMs of the trading parameters established for the customer. Examiners should also confirm that the FCM personnel responsible for accepting or rejecting an executed trade for clearance have sufficient current information to determine whether the trade is consistent with the customer’s trading limits. Prudent give-up agreements (or other relevant documents such as the customer account agreement) should permit the FCM to adjust the customer’s transaction limits when appropriate in light of market conditions or changes in the customer’s financial condition.

Some FCMs act as the primary clearing firm (also referred to as the sponsoring or qualifying

firm) for customers.<sup>11</sup> A primary clearing firm guarantees to the clearinghouse that it will accept and clear all trades submitted by the customer or executing FCM, even if the trade is outside the agreed-on limits. Because an FCM is obligated to accept and clear all trades submitted by its primary clearing customers, the FCM must be able to monitor its customers’ trading activities on an intraday basis for compliance with agreed-on trading limits. Monitoring is especially important during times of market stress. The FCM should be ready and able to take immediate steps to address any unacceptable risks that arise, for example, by contacting the customer to obtain additional margin or other assurances, approving a limit exception, taking steps to liquidate open customer positions, or giving appropriate notice of termination of the clearing arrangement to enable the FCM to reject future transactions.

Intraday monitoring techniques will vary depending on the technology available at the particular exchange. A number of the larger, more automated U.S. exchanges have developed technologies that permit multiple intraday collection, matching, and reporting of trades—although the frequency of such reconciliations varies. On exchanges that are less automated, the primary clearing FCM must develop procedures for monitoring clearing-only risks. For example, the FCM could maintain a significant physical presence on the trading floor to monitor customer trading activities and promote more frequent collection (and tallying) of trade information from clearing-only customers. The resources necessary for such monitoring obviously will depend on the physical layout of the exchange—the size of the trading floor and the number of trading pits, the floor population and daily trading volumes, and the level of familiarity the FCM has with the trading practices and objectives of its primary clearing customers. The FCM should be able to increase its floor presence in times of market stress.

#### *3250.0.7.1.4 Carrying-Broker Risk*

An FCM may enter into an agreement with another FCM to execute and clear transactions

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11. Primary clearing customers include institutions and individuals, as well as other nonclearing futures professionals (locals or floor traders), who execute their own trades on the exchange and other nonclearing FCMs that execute trades for unaffiliated customers.

on behalf of the first FCM (typically, when the first FCM is not an exchange or clearing member of an exchange). In such cases, the FCM seeking another or carrying FCM to execute its transactions should have procedures for reviewing the creditworthiness of the carrying FCM. If the FCM reasonably expects that the carrying FCM will use yet another FCM to clear its transactions (for example, if the carrying FCM enters into its own carrying-broker relationship with another firm for purposes of executing or clearing transactions on another exchange), the first FCM should try to obtain an indemnification from the carrying FCM for any losses incurred on these transactions.<sup>12</sup> When carrying transactions occur on a foreign exchange, an FCM should know about the legal ramifications of the carrying relationship under the rules of the exchange and the laws of the host country. Moreover, it may be appropriate for an FCM to reach an agreement with its customers that addresses liabilities relative to transactions effected on a non-U.S. exchange by a carrying broker.

#### *3250.0.7.1.5 Executing-FCM Risk*

When an FCM uses an unaffiliated FCM to execute customer transactions under a give-up arrangement, the clearing firm that sponsors the executing FCM guarantees its performance. Therefore, the first FCM should review the subcontracting risk of its executing FCMs and their sponsoring clearing firms. However, unlike the clearing risk inherent in a carrying-broker relationship, the subcontracting risk for an FCM using an executing FCM is limited to transaction risk (execution errors). An FCM's management should approve each executing broker it uses, considering the broker's reputation for obtaining timely executions and the financial condition of its sponsoring clearing firm.

#### *3250.0.7.1.6 Pit-Broker Risk*

Usually, FCMs will subcontract the execution of their orders to unaffiliated pit brokers who accept

and execute transactions for numerous FCMs during the trading day. The risk associated with using a pit broker is similar to that of using an executing broker: the risk is limited to the broker's performance in completing the transaction. If the pit broker fails, then the primary clearing firm is responsible for completing the transaction. Therefore, an FCM should approve each pit broker it uses, considering the pit broker's reputation for obtaining timely executions and the resources of its sponsoring clearing firm.

#### *3250.0.7.1.7 Clearinghouse Risk*

Clearinghouse risk is the potential that a clearinghouse will require a member to meet loss-sharing assessments caused by another clearing member's failure. Before authorizing membership in an exchange or clearinghouse, an FCM's board of directors and its parent company must fully understand the initial and ongoing regulatory and financial requirements for members. The FCM's board of directors should approve membership in a clearinghouse only after a thorough consideration of the financial condition, settlement and default procedures, and loss-sharing requirements of the clearinghouse.

Particularly when it is considering membership in a foreign exchange or clearinghouse, an FCM's board should examine any regulatory and legal precedents related to how the exchange, clearinghouse, or host country views loss-sharing arrangements. As in the United States, some foreign clearinghouses have unlimited loss-sharing requirements, and some have "limited" requirements that are set at very high percentages. However, the loss-sharing provisions of some of the foreign clearinghouses have not yet been applied, which means that there are no legal and regulatory precedents for applying the stated requirements. In addition, the board should be apprised of any differences in how foreign accounts are viewed, for example, whether customer funds are considered separate from those of the FCM, whether the relationship between an FCM and its customer is viewed as an agency rather than a principal relationship, and whether there are material differences in the way futures activities are regulated.

The board also should be apprised of any material changes in the financial condition of every clearinghouse of which the FCM is a member. Senior management should monitor the financial condition of its clearinghouses as part of its risk-management function.

12. The CFTC takes the position that an FCM is responsible to its customers for losses arising from the failure of the performance of a carrying broker. The industry disagrees with this position, and the issue has not been resolved by the courts.

### 3250.0.7.1.8 *Guarantees*

FCM parent companies often are asked to provide assurances to customers and clearinghouses that warrant the FCM's performance. These arrangements may take the form of formal guarantees or less formal letters of comfort.

Under Regulation Y (section 225.28(b)(7)(iv)(B)), a bank holding company may not provide a guarantee to a clearinghouse for the performance of the FCM's customer obligations. A bank holding company may provide a letter of comfort or other agreement to the FCM's customers that states the parent (or affiliate) will reimburse the customers' funds on deposit with the FCM if they are lost as a result of the FCM's failure or default. Customers may seek this assurance to avoid losses that could arise from credit exposure created by another customer of the FCM, since the clearinghouse may use some or all of the FCM's customer-segregated funds in the event of a default by the FCM stemming from a failing customer's obligations.<sup>13</sup> Examiners should note any permissible guarantees for purposes of the consolidated report of the parent bank holding company, as they are relevant to calculating the consolidated risk-based capital of the bank holding company.

### 3250.0.7.2 *Market Risk*

When an FCM acts as a broker on behalf of customers, it generally is only subject to market risk if it executes customers' transactions in error. In this regard, operational problems can expose the FCM to market fluctuations in contract values. However, when an FCM engages in proprietary trading, such as market making and other position-taking, it will be directly exposed to market risk. Potential market-risk exposure should be addressed appropriately in an FCM's policies and procedures.

An FCM that engages in proprietary trading should establish market-risk and trading parameters approved by its parent company. The FCM's senior management should establish an independent risk-management function to control and monitor proprietary trading activities. Finally, the FCM should institute procedures to control potential conflicts of interest between its brokerage and proprietary trading activities.

13. The letter of comfort would protect customers whose funds were used to cover other customer losses by the clearinghouse. U.S. clearinghouses also have guarantee funds that can be used to reimburse customers at the clearinghouse's discretion.

### 3250.0.7.3 *Liquidity Risk*

Liquidity risk is the risk that the FCM will not be able to meet its financial commitments (end-of-day and intraday margin calls) to its clearing FCM or clearinghouse. Clearing FCMs are required to establish an account at one of the settlement banks used by the clearinghouse for its accounts and the accounts of its clearing members. In some foreign jurisdictions, the central bank fulfills this settlement function. An FCM should establish and monitor daily settlement limits for its customers and should ensure that there are back-up liquidity facilities to meet any unexpected shortfalls in same-day funds. To ensure the safety of its funds and assets, an FCM should also monitor the financial condition of the settlement bank it has chosen and should be prepared to transfer its funds and assets to another settlement bank, when necessary.

To control other types of liquidity risks, an FCM should adopt contingency plans for liquidity demands that may arise from dramatic market changes. An FCM, to the extent possible, should monitor the markets it trades in to identify undue concentrations by others that could create an illiquid market, thereby creating a risk that the FCM could not liquidate its positions. Most U.S. clearinghouses monitor concentrations and will contact an FCM that holds more than a certain percentage of the open interest in a product. In some situations, the exchange could sanction or discipline the FCM if it finds that the FCM, by holding the undue concentration, was attempting to manipulate the market. These prudential safeguards may not be in place on foreign exchanges; consequently, an FCM will have to establish procedures to monitor its liquidity risk on those exchanges.

### 3250.0.7.4 *Reputation Risk*

FCMs should have reporting procedures in place to ensure that any material events that harm its reputation, and the reputations of its bank affiliates, are brought to the attention of senior management; the FCM's board of directors; and, when appropriate, its parent company. Reports of potentially damaging events should be sent to senior management at the parent bank holding company, who will evaluate their effect on the FCM to determine what, if any, steps should be taken to mitigate the impact of the event on the whole organization.

#### 3250.0.7.4.1 *Commodity Trading Adviser*

Acting as a commodity trading adviser (including providing discretionary investment advice to retail and institutional customers or commodity pools) may pose reputation and litigation risks to a CTA or an FCM, particularly when retail customers are involved. Accordingly, the FCM's board should adopt policies and procedures addressing compliance with CFTC and NFA sales-practice rules (including compliance with the "know your customer" recordkeeping rules).

### 3250.0.7.5 Operations Risk, Internal Controls, Internal Audits, and Compliance

#### 3250.0.7.5.1 *Operations Risk*

Operations risk is the potential that deficiencies in information systems or internal controls will result in unexpected loss. Some specific sources of operating risk at FCMs include inadequate procedures, human error, system failure, or fraud. For FCMs, failure to assess or control operating risks accurately can be a likely source of problems. Back-office or transaction-processing operations are an important source of operations-risk exposures. In conducting reviews of back-office operations, examiners should consult the appropriate chapters of the *Trading and Capital-Markets Activities Manual* for further guidance.

Operations risk also includes potential losses from computer and communication systems that are unable to handle the volume of FCM transactions, particularly in periods of market stress. FCMs should have procedures that address the operations risks of these systems, including contingency plans to handle systems failures and back-up facilities for critical parts of risk-management, communications, and accounting systems.

When FCMs execute or clear transactions in nonfinancial commodities, they may have to take delivery of a commodity because a customer is unable or unwilling to make or take delivery on its contract. To address this situation, the FCM should have in place the procedures it will follow to terminate its position and avoid dealing in physical commodities.

#### 3250.0.7.5.2 *Internal Controls*

Adequate internal controls are the first line of defense in controlling the operations risks

involved in FCM activities. Internal controls that ensure the separation of duties involving account acceptance, order receipt, execution, confirmation, margin processing, and accounting are particularly important. Internal controls should also be established to record, track, and resolve errors and discrepancies with customers and other parties.

FCMs should have approved policies that specify documentation requirements for transactions and formal procedures for saving and safeguarding important documents, consistent with legal requirements and internal policies. Relevant personnel should fully understand documentation requirements. Examiners should also consider the extent to which entities evaluate and control operations risks through internal audits, contingency planning, and other managerial and analytical techniques.

#### 3250.0.7.6 Internal Audits and Their Review

An FCM should be subject to regular internal audits to confirm that it complies with its policies and procedures and is managed in a safe and sound manner. In addition, the internal audit function should review any significant issues raised by compliance personnel to ensure that they are resolved. Other staff within the FCM (i.e., compliance personnel) should be able to reach internal audit staff to discuss any serious concerns they might have. Internal audit reports should be forwarded to the FCM's senior management. Material findings and management's plan to resolve the audit issues should be reported to the FCM's board of directors, the parent company, and any designated board committee (for example, an audit committee). Frequently, the internal audit function is located at the parent company, and audit reports are routinely sent to senior management at the parent company and to the audit committee designated by the board of directors.

### 3250.0.8 INSPECTION GUIDANCE

The review of an FCM's functions should take a functional-regulatory approach, using the findings of the FCM's primary regulators as much as possible. Examiners should especially focus on the significant risks that the FCM poses to the parent company and affiliated banks. These risks should be assessed by reviewing the

adequacy of the FCM's policies and procedures, internal controls, and risk-management functions. Compliance with policies and procedures, and with any conditions on the FCM's activities imposed by regulatory authorities (including the Federal Reserve Board), should be fully reviewed.

Bank holding companies, banks, and FBOs may have more than one subsidiary that acts as an FCM in the United States or that engages in futures transactions for customers in foreign markets. To ensure that the FCM/CTA activities of a banking organization are evaluated on a consolidated basis, a cross-section of affiliated futures brokerage and advisory firms should be reviewed periodically—particularly those that present the greatest risk to the consolidated financial organization. Relevant factors to consider when identifying firms for review include (1) the volume of business; (2) whether the FCM has unaffiliated customers; (3) the number of customers; (4) whether the firm provides customer financing; (5) the number of brokers effecting transactions; (6) whether exchange or clearinghouse memberships are involved; (7) whether the FCM provides clearing-only services; and (8) the date and scope of the last review conducted by the Federal Reserve, SRO, or other regulator.

The scope of any review to be conducted depends on the size of the FCM and the scope of its activities. The draft first-day letter should provide an overview of an FCM's authorized activities and conditions, as well as a description of the actual scope of its business. Examiners should review the most recent summary of management points or other inspection results issued by the FCM's SRO or other regulator, as well as any correspondence between the FCM and any federal agency or SRO. If examiners have any questions about the findings of an SRO's or a regulator's results, they should contact the organization to determine whether the matter is material and relevant to the current inspection. The status of any matters left open after the SRO's or regulator's review should also be inquired about.

An important factor in determining the scope of the inspection is whether the FCM has unaffiliated customers or conducts transactions solely for affiliates. Other factors include whether (1) the FCM is a clearing member of an exchange, particularly of a non-U.S. exchange; (2) it acts as a carrying broker on behalf of other FCMs; (3) it has omnibus accounts with other brokers in markets in which it is not a member (U.S. or foreign); (4) it provides advisory or portfolio management services, including discretionary accounts, or has been authorized to act as a

commodity pool operator (CPO); (5) it provides clearing services to locals or market-makers; and (6) it provides financing services to customers.<sup>14</sup>

Examiners are not expected to routinely perform a front- or back-office inspection unless (1) the FCM's primary regulator found material deficiencies in either office during its most recent examination or (2) if front- or back-office operations have not been examined by the primary regulator within the last two years. However, examiners may still choose to review a small sample of accounts and transactions to confirm that appropriate controls are in place. In addition, net capital computations of U.S. FCMs do not need to be reviewed; they are reviewed by the FCM's DSRO, and the FCM is subject to reporting requirements if capital falls below warning levels. Examiners should perform a front- and back-office review of the FCM's operations outside of the United States.<sup>15</sup>

*Review of audit function.* Examiners may rely on well-documented internal audit reports and workpapers to verify the adequacy of risk management at the FCM. Examiners should review the internal audit reports and workpapers to determine the adequacy of their scope and thoroughness in complying with FCM policies and procedures. If an examiner finds that an internal audit adequately documents the FCM's compliance with a policy or procedure pertaining to the management of the various risk assessments required by the current inspection, that fact should be documented in the workpapers, and inspection procedures should be completed in any area not adequately addressed by the internal audit report. Examiners should periodically spot check areas covered by internal audits to ensure the ongoing integrity of the audit process. Finally, examiners should ensure that internal auditors have adequate training to evaluate

14. If the FCM engages in proprietary trading for its own account, particularly for purposes other than hedging (market making or position taking), or if the FCM acts as an intermediary in any over-the-counter futures or other derivative activities, the examiner should advise the examiner in charge of the inspection so that the firm's proprietary trading can be evaluated in connection with similar activities of the consolidated financial organization.

15. The inspection procedures for reviewing front- and back-office operations may be found in sections 2050.3 and 2060.3, respectively, of the *Trading and Capital-Markets Activities Manual*.

the FCM's compliance with its policies and procedures and with applicable laws and regulations (both inside and, if applicable, outside the United States).

If an examiner has determined that it is not necessary to perform a routine back-office review, he or she should confirm that the FCM has addressed operations risks in its policies and procedures. Examiners also should review the internal controls of an FCM to ensure that the firm is operated safely and soundly according to industry standards and that it complies with any Board regulations or conditions placed on the FCM's activities. Examiners should be alert to any "red flags" that might indicate inadequate internal controls. An FCM must be organized so that its sales, operations, and compliance functions are separate and managed independently. If an FCM engages in proprietary trading, examiners should confirm that the firm has procedures that protect against conflicts of interest in the handling of customer orders (examples of these conflicts of interest include front-running or ex-pit transactions). To make an overall assessment of the FCM's future business, the results of any review should be consolidated with the results of reviews by other FCMs inspected during this cycle.

### 3250.0.9 INSPECTION OBJECTIVES

1. To identify the potential and extent of various risks associated with the FCM's activities, including credit, market, liquidity, and reputation risks.
2. To evaluate the adequacy of the audit function and review significant findings, the method of follow-up, and management's response to correct any deficiencies.
3. To assess the adequacy of the risk-management function at the FCM.
4. To assess the adequacy of and compliance with the FCM's policies and procedures and the adequacy of the internal control function.
5. To evaluate and determine the FCM's level of compliance with relevant statutes, Board regulations, interpretations, orders, and policies.
6. To assess the adequacy of risk management of affiliated FCMs on a consolidated basis.

### 3250.0.10 INSPECTION PROCEDURES

#### 3250.0.10.1 Structural Organization and Activity Analysis

##### 3250.0.10.1.1 General

1. Identify all bank holding company subsidiaries that engage in FCM- or CTA-type activities in the United States or abroad or identify U.S. FCM/CTA subsidiaries of FBOs. Determine which firms should be inspected to provide a global view of the adequacy of management of these activities on a consolidated basis, based on the scope of activities and the degree of supervision by other regulators. Complete applicable procedures below for firms selected for inspection.
2. Review first-day-letter documents, notices filed under Regulation Y, Board orders and letters authorizing activities, previous inspection reports and workpapers, previous audit reports by futures regulators (CFTC, DSRO, National Futures Association, foreign futures regulator) and correspondence exchanged with those regulatory entities, and reports by internal or external auditors or consultants.
3. Note the scope of the FCM's activities, including—
  - a. execution and clearing;
  - b. execution only for affiliates and third parties;
  - c. clearing-only for affiliates, third parties, professional floor traders (locals);
  - d. pit brokerage;
  - e. advisory;
  - f. discretionary portfolio management;
  - g. commodities or commodity pool operator (in FCM or in affiliate);
  - h. margin financing;
  - i. proprietary trading;
  - j. exchange market maker or specialist;
  - k. types of instruments (for example, financial, agricultural, precious metals, petroleum);
  - l. contract markets where business is directed;
  - m. other derivatives products (should be identified, for example, interest-rate swaps and related derivative contracts, foreign-exchange derivative contracts, foreign government securities, other);
  - n. other futures-related activities, including off-exchange transactions;
  - o. riskless-principal transactions; and
  - p. registered broker-dealers.
4. Note exchange and clearinghouse memberships here and abroad, noting any financial commitments and any guarantees by the FCM

or its parent<sup>16</sup> to the exchange or clearinghouse with respect to proprietary, affiliate, or customer transactions.

5. Note any new lines of business or activities occurring at the FCM or any changes to exchange and clearing memberships since the last inspection.
6. Note the percentage of business conducted for—
  - a. affiliate banks,
  - b. nonbank affiliates,
  - c. customers (note the breakdown between institutional and retail customers and if there is any guarantee or letter of comfort to customers in which the parent company provides that it will reimburse customers for loss as a result of the FCM's failure or other default),
  - d. proprietary accounts (hedging, position-taking), and
  - e. professional floor traders (locals, market makers).

#### *3250.0.10.1.2 Audit Program*

Determine the quality of the internal audit program. Assess the scope, frequency, and quality of the audit program for the FCM and related activities. Consider spot checking areas covered by internal audits.

1. Review the most recent audit report, noting any exceptions and their resolution.
2. Determine whether internal auditors have adequate training to evaluate the FCM's compliance with its policies and procedures and with applicable laws and regulations.
3. Verify that audit findings have been communicated to senior management and material findings have been reported to the FCM's board of directors and parent company.
4. Identify any areas covered by these procedures that are not adequately addressed by the internal audit report.
5. Identify areas of the internal audit report that should be verified as part of the current inspection.

#### *3250.0.10.1.3 Operational Activities*

Determine the scope of review that is appropriate to activities and allocate examiner resources,

considering the adequacy of internal audit workpapers.

1. Complete the appropriate front- and/or back-office inspection procedures when—
  - a. front- and back-office operations have not been examined by the DSRO within the last two years,
  - b. material deficiencies in front- or back-office operations were found by the DSRO during the most recent audit, or
  - c. the primary regulator for the FCM is not a U.S. entity.
2. Advise the examiner in charge of the inspection of the parent company if the FCM engages in proprietary trading or over-the-counter futures or derivatives business as principal or agent.

#### *3250.0.10.2 Board and Senior Management Oversight*

1. Review the background and experience of the FCM's board of directors and senior management, noting prior banking and futures brokerage experience.
2. Determine if the board of directors of the FCM has approved written policies summarizing the firm's activities listed below, and addressing oversight by the board or a board-designated committee:
  - a. the risk appropriate for the FCM, including credit, market, liquidity, operation, reputation, and legal risk (see SR-95-51)
  - b. the monitoring of compliance with risk parameters
  - c. the exchange and clearinghouse memberships
  - d. the internal audit function
3. Determine if senior management of the FCM has adopted procedures implementing the board's policies for—
  - a. approval of new-product lines and other activities;
  - b. transactions with affiliates;
  - c. transactions by employees;
  - d. compliance with applicable regulations and policies and procedures;
  - e. management information reports;
  - f. the separation of sales, operations, back-office, and compliance functions; and
  - g. reports to the FCM boards of directors on material findings of the complaint or audit

<sup>16</sup> The parent bank holding company cannot provide a guarantee or otherwise become liable to an exchange or clearing association other than for those trades conducted by the FCM subsidiary for its own account or for the account of any affiliate. See Regulation Y, section 225.28(b)(7)(iv)(B).

functions and on material deficiencies identified during the course of regulatory audits or inspections.

4. Determine that policies and procedures are periodically reviewed by the board of directors or senior management, as appropriate, and ensure that they comply with existing regulatory and supervisory standards and address all of the FCM's activities.
5. Review management information reporting systems and determine whether the board of directors of the parent company (or a designated committee of the parent's board) is apprised of—
  - a. material developments at the FCM,
  - b. the financial position of the firm including significant credit exposures,
  - c. the adequacy of risk management,
  - d. material findings of the audit or compliance functions, and
  - e. material deficiencies identified during the course of regulatory reviews or inspections.
6. Review the FCM's strategic plan.
  - a. Assess whether there are material inconsistencies between the stated plans and the FCM's stated risk tolerances.
  - b. Verify that the strategic plan is reviewed and periodically updated.

### 3250.0.10.3 Risk Management

#### 3250.0.10.3.1 *Credit Risk*

1. Review credit-risk policies and procedures.
  - a. Verify the independence of credit-review approval from the limit-exceptions approval.
  - b. Verify that the procedures designate a senior officer with the responsibility to monitor and approve limit-exception approvals.
2. Determine whether the FCM has authority to open customer accounts without parent company approval.
3. Review the customer base (affiliates, third parties) for credit quality in terms of affiliation and business activity (affiliates, corporate, retail, managed funds, floor traders, etc.).
4. Evaluate the process for customer-credit review and approval. Determine whether the customer-credit review identifies credit

risks associated with the volume of transactions executed or cleared for the customer.

5. Evaluate the adequacy of credit-risk-management policies. Determine if they—
  - a. establish and require adequately documented credit limits for each customer that reflect their respective financial strengths, liquidity, trading objectives, and potential market risk associated with the products traded;
  - b. require periodic updates of such credit limits in light of changes in the financial condition of each customer and market conditions; and
  - c. do not permit the FCM to waive important broker safeguards, such as the right to liquidate customer positions upon default or late payment of margin.
6. Consider verifying the above information by sampling customer-credit files.
7. Verify that up-to-date customer-credit files are maintained on site or are available for review during the inspection. If the customer-credit approval was performed by the parent company or an affiliate bank, verify that the FCM's files contain information indicating the scope of the credit review, the approval, and credit limits.
8. Review notifications and approval of limit exceptions for compliance with FCM procedures.
9. Determine whether the FCM has adopted procedures identifying when the FCM should take steps to limit its customer-credit exposure (for example, when to refuse a trade, grant a limit exception, transfer positions to another FCM, or liquidate customer positions).
10. Evaluate the adequacy of risk management of customer-financing activities.
11. Determine that the credit-review process is independent from the marketing, sales, and financing function.
  - a. Verify that the FCM has policies that identify customer-credit standards and that it establishes overall lending limits for each customer.
  - b. Assess the adequacy of the credit-review process and documentation, even when credit review is performed by an affiliate.
12. Review the instances when the FCM has lent margin to customers on an unsecured basis. If the FCM does not engage in margin financing as a business line, verify that extensions are short-term and within the operational threshold set for the customer.

*3250.0.10.3.2 Clearing-Only Risk*

1. Determine whether each clearing arrangement is in writing and that it—
  - a. identifies the customer and executing brokers, and defines and adequately documents the respective rights and obligations of each party;
  - b. establishes overall limits and trading parameters for the customer that are based on the customer's creditworthiness and trading objectives; and
  - c. permits transaction limits to be adjusted to accommodate market conditions or changes in the customer's financial condition.
2. When the FCM has entered into a clearing-only agreement with a customer, verify that it has reviewed the creditworthiness of each executing broker or its qualifying clearing firm identified in the agreement.
3. If the FCM acts as the primary clearing firm for locals or other customers, confirm that the firm has adopted procedures for monitoring and controlling exposure. Note whether the firm monitors customer positions throughout the trading day and how this monitoring is accomplished.

*3250.0.10.3.3 Carrying Brokers, Executing Brokers, and Pit Brokers*

1. If the FCM uses other brokers to execute and/or clear transactions, either on an omnibus or a fully disclosed basis, determine that it has adequately reviewed the creditworthiness and approved the use of the other brokers. If the FCM uses nonaffiliated executing brokers, confirm that it also has considered the reputation of the broker's primary clearing firm. If the other broker is likely to use another broker, determine whether the broker has given the FCM an indemnification against any loss that results from the performance or failure of the other broker.
2. If the FCM uses other brokers to execute or clear transactions in non-U.S. markets, determine whether senior management understands the legal risks pertinent to doing business in those markets and has adopted policies for managing those risks.
3. When the FCM uses third-party "pit brokers" to execute transactions, verify that the FCM has reviewed and approved each broker after considering the reputation of the pit broker's primary clearing firm.

*3250.0.10.3.4 Exchange and Clearinghouse Membership*

1. Verify that the FCM completes a due-diligence study of each exchange and clearinghouse before applying for membership in the organization.
  - a. Determine whether board minutes approving membership demonstrate a thorough understanding of the loss-assessment provisions and other obligations of membership for each exchange and clearinghouse, as well as a general understanding of the regulatory scheme.
  - b. Determine whether, in approving membership in a non-U.S. exchange or clearinghouse, the board's minutes indicate a discussion of the regulatory environment and any relevant credit, liquidity, and legal risks associated with doing business in the particular jurisdiction. The minutes should also reflect discussion of any material differences from U.S. precedent in how foreign accounts are viewed, for example, whether customer funds held in an omnibus account are considered separate (segregated) from those of the FCM or whether the relationship between the FCM and its customers is viewed as an agency or principal relationship in the host country.
2. Verify that the FCM has apprised its parent company of the results of its study of the exchange or clearinghouse and that it has written authorization by senior management of its parent company to apply for membership.
3. Verify that the FCM monitors the financial condition of each exchange and clearing organization for which it is a member.
4. Review all guarantees, letters of comfort, or other forms of potential contingent liability. Verify that the parent company has not provided a guarantee to the clearinghouse for the performance of the FCM's customer obligations.<sup>17</sup> Note any guarantees against the parent losses incurred from the failure of an FCM and advise the examiner in charge of the parent company's inspection, who can confirm that guarantees are included in the

17. The parent bank holding company cannot provide a guarantee or otherwise become liable to an exchange or clearing association other than for those trades conducted by the FCM subsidiary for its own account or for the account of any affiliate. See Regulation Y, section 225.28(b)(7)(iv)(B).

bank holding company's calculation of consolidated risk-based capital.

### 3250.0.10.3.5 *Market Risk*

1. If an FCM engages in proprietary trading, determine whether policies and procedures are in place to control potential conflicts of interest between its brokerage business and trading activities.
2. When an FCM plans to enter (or has entered into) a foreign market, determine if the FCM performed due-diligence reviews of relevant legal and regulatory issues, as well as on local business practices.

### 3250.0.10.3.6 *Liquidity Risk*

1. Verify that the FCM has established and monitors daily settlement limits for each customer to ensure that liquidity is sufficient to meet clearinghouse obligations.
2. Determine whether the FCM has established back-up liquidity facilities to meet unexpected shortfalls.
3. Verify that the FCM monitors by product the amount of open interest (concentrations) that it holds at each exchange, either directly or indirectly through other brokers. If positions are held on foreign exchanges and concentrations are not monitored, verify that the FCM is able to monitor its positions and manage its potential liquidity risks arising from that market.
4. Review liquidity contingency plans for dealing with dramatic market changes.

### 3250.0.10.3.7 *Reputation Risk*

1. Review management information reporting systems and determine whether—
  - a. the FCM is able to assess the extent of any material exposure to legal or reputation risk arising from its activities, and
  - b. the parent company receives sufficient information from the FCM to assess the extent of any material exposure to litigation or reputation risk arising from the FCM's activities.
2. If the FCM provides investment advice to customers or commodity pools, determine whether it has procedures designed to mini-

mize the risks associated with advisory activities. Such procedures might address the delivery of risk disclosures to customers, the types of transactions and trading strategies that could be recommended or effected for retail customers, compliance with the “know your customer” recordkeeping and other sales practice rules of the SROs, and conformance to any trading objectives established by the customer or fund.

3. If the FCM acts as a CPO, verify that it has obtained prior Board approval and is in compliance with any conditions in the Board order.

### 3250.0.10.4 *Operations, Internal Controls, and Compliance*

1. Determine the extent to which operating risk is evaluated and controlled through the use of internal audits, contingency planning, and other managerial and analytical techniques.
2. Review the most recent summary of management points or similar document and also respective correspondence issued by the FCM's DSRO or other primary futures regulator. Discuss any criticism with FCM management and confirm that corrective action has been taken.
3. Consider reviewing a small sample of accounts and transactions to confirm that appropriate controls are used and that the FCM has incorporated operations risks into its policies and procedures.
4. Review the organizational structure and reporting lines within the FCM and verify separation of sales, trading, operations, compliance, and audit functions.
5. Determine that the FCM's policies and procedures address the booking of transactions by affiliates and employees and other potential conflicts of interest.
6. If the FCM is authorized to act as a CPO, review the most recent NFA or other primary futures regulator's audit, including any informal findings by examiners. Discuss any criticism with the FCM management and confirm that corrective action has been taken.
7. If the FCM executes and clears nonfinancial futures, verify that the FCM has procedures to avoid taking physical possession of the nonfinancial product when effecting “exchange for physical transactions” for customers.

8. When the FCM takes physical delivery of commodities due to failure or unwillingness of a customer to make or take delivery of its contracts, determine whether the FCM has and follows procedures to close out its position. Note if the FCM frequently takes delivery of physical commodities.

9. Assess the adequacy of customer-complaint review by reviewing the complaint file and how complaints are resolved. Note if the FCM receives repeat or multiple complaints involving one or more of its activities or employees.

10. Determine whether the FCM has developed contingency plans that describe actions to be taken in times of market disruptions and

whether such plans address management responsibilities, including communications with its parent bank holding company, liquidity, the effect on customer-credit quality, and communications with customers.

3250.0.10.5 Conclusions

1. Prepare inspection findings and draw conclusions as to the adequacy of the FCM’s risk-management, compliance, operations, internal controls, and audit functions.

2. Present findings to FCM management and submit inspection findings to the examiner in charge of the parent company inspection.
- 3250.0.11 FCM Supplemental Checklist Questionnaire
- |  | Yes   | No    |
|--|-------|-------|
| 3250.0.11.1 General Questions  |       |       |
| 1. Is the FCM a separately incorporated subsidiary of the bank holding company as required by Regulation Y, 12 C.F.R. 225.28(b)(6)(iv)?  | _____ | _____ |
| 2. Has the parent bank holding company provided a guarantee or otherwise become liable to an exchange or clearing association other than for those trades conducted by a subsidiary for its own account or for the account of any affiliate (prohibited by Regulation Y (see 12 C.F.R. 225.28(b)(6)(iv)))? | _____ | _____ |
| 3. How long has the FCM been in operation?_____yrs.  |       |       |
| 4. Approximately how many customers does the FCM have?_____  |       |       |
| 5. What degree of market participation does the FCM have (mark (x) for the highest level of involvement)?  |       |       |
| a. _____ FCM, nonmember of futures exchange.<br>Must execute trades through exchange members and is subject to NFA rules.  |       |       |
| b. _____ Exchange member. Holds membership on one or more futures exchanges entitling FCM to execute trades on the exchange(s) and subjecting FCM to the rules of exchange(s).   |       |       |
| c. _____ Clearinghouse member. Holds membership in an exchange’s clearinghouse as well as exchange membership, thus enabling FCM to execute and clear its own transactions. Such FCM is subject to exchange and clearinghouse rules.   |       |       |
| 6. If FCM is an exchange member, on which exchange(s) (domestic and foreign) does the FCM have membership(s)?  |       |       |
| _____  |       |       |
| _____  |       |       |
| _____  |       |       |
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	Yes	No
7. If FCM is a clearing member, list below the clearinghouse(s) of which it is a member.		
8. Does the FCM periodically make an adjusted net capital computation to verify that it maintains capitalization fully adequate to meet its own commitments and those of its customers, including affiliates?		
(NOTE: Under the CFTC’s net capital computations, there have been no capital requirements for “hedge” transactions by FCM affiliate banks. It may be necessary to request that an adjusted net capital computation be made to determine the amount of adjusted net capital required when affiliate trades are treated as third-party transactions.)		
9. Does a review of the FCM’s correspondence from its designated self-regulatory organization reveal that the FCM meets CFTC requirements with respect to capital rules, segregation of customer assets, and risk disclosure?		
10. If an FCM will receive services from an affiliate (e.g., the lead bank assesses FCM customer-credit risk or monitors customer positions and margin accounts), have the FCM and affiliate entered into a formal service agreement on an explicit fee basis?		

3250.0.11.2 Management

1. Does the FCM’s management have expertise and previous experience as a broker, dealer, or participant in cash, futures, or forward markets related to those in which the FCM executes transactions?		
2. Does the FCM’s management have prior banking experience?		
3. Does it appear that management has the expertise necessary to evaluate the viability of various hedging strategies?		
4. Does it appear that FCM management has the ability to recognize imprudent or unsafe customer activity that could endanger the FCM?		
5. Does the board of directors have written policies that summarize the firm’s activities and its oversight function (certain functions may be designated to a board audit or other committee) with respect to—		
a. risk appropriate for the FCM?		
b. compliance monitoring and risk parameters?		

3250.0.11.3 Controls of Risk Exposure with Customers

1. Does the FCM have a system for assessing and periodically re-evaluating customer-credit risk?		
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	<i>Yes</i>	<i>No</i>
2. Does the FCM take customer-credit risk into consideration and establish for each customer—	_____	_____
a. position limits for each contract the customer wishes to trade?	_____	_____
b. an aggregate position limit for outstanding contracts held by each customer?	_____	_____
3. Does the FCM have a system for monitoring customer positions to ensure positions are within the limits imposed by the FCM?	_____	_____
4. Does the FCM have an adequate system in place to monitor its overall risk exposure, primarily customer-default risk, on a daily basis?	_____	_____
5. Do customer agreements and internal procedures enable the FCM to—		
a. limit the types of trades a customer engages in?	_____	_____
b. refuse, when appropriate, to execute any trades except those resulting in liquidation of existing positions?	_____	_____

#### 3250.0.11.4 Margin Requirements

1. Does the FCM have a system for daily monitoring of margin accounts to ensure that margin calls are promptly issued and satisfied?	_____	_____
2. Does the customer agreement permit and has the FCM adopted procedures for liquidating a customer's position if margin calls are not promptly satisfied?	_____	_____
3. Do customer-account agreements authorize the FCM to require higher initial and variation margin levels than those set by the exchanges?	_____	_____
4. Does the FCM have a system in place for obtaining higher customer margins in instances when the FCM determines—	_____	_____
a. a customer's futures position or deteriorating financial condition necessitates a greater amount of margin to protect the FCM?	_____	_____
b. volatile market conditions justify higher levels of margin than those required by an exchange?	_____	_____

#### 3250.0.11.5 Credit Risk

1. Is the credit-review approval independent from the limit-exceptions approval?	_____	_____
2. Does a senior officer monitor and approve limit-exception approvals?	_____	_____
3. Does the customer-credit review identify credit risks associated with the volume of transactions executed or cleared for the customer?	_____	_____
4. Is adequate documentation required and maintained of credit limits for each customer that reflect customers' respective financial strengths and liquidity, trading objectives, and the potential market risk associated with the products traded?	_____	_____
5. Has the FCM adopted procedures identifying when the FCM should take steps to limit its customer-credit exposure (e.g., when to refuse a trade, grant a limit exception, transfer positions to another FCM, or liquidate customer positions)?	_____	_____
6. Is the credit-review process independent from the marketing/sales function and the financing function?	_____	_____

	Yes	No
3250.0.11.6 Clearing-Only Risk		
1. Is each arrangement in writing and does it—		
a. identify the customer, executing brokers, and define and adequately document the respective rights and obligations of each party?	_____	_____
b. establish overall limits and trading parameters for the customer that are based on the customer’s creditworthiness and trading objectives?	_____	_____
c. permit transaction limits to be adjusted to accommodate market conditions or changes in the customer’s financial condition?	_____	_____
2. Has the FCM or its qualifying clearing firm verified that it has reviewed the creditworthiness of each executing broker?	_____	_____
3. If the FCM acts as the primary clearing firm for locals or other customers, has the firm adopted procedures for monitoring and controlling exposure throughout the trading day?	_____	_____
3250.0.11.7 Carrying Brokers, Executing Brokers, and Pit Brokers		
1. If the FCM uses other brokers to execute and/or clear transactions, either on an omnibus or fully disclosed basis, has it adequately reviewed the creditworthiness and approved the use of the other brokers?	_____	_____
2. Has the FCM been given an indemnification against any loss that results from the performance or failure of the other broker?	_____	_____
3. If the FCM uses nonaffiliated executing brokers, has it considered the reputation of the broker’s primary clearing firm?	_____	_____
3250.0.11.8 Exchange and Clearinghouse Membership		
1. Does the FCM complete a due-diligence study of each exchange and clearinghouse before applying for membership in such organization?	_____	_____
2. Do the board minutes approving such memberships demonstrate a thorough understanding of the loss-assessment provisions and other obligations of membership for each exchange and clearinghouse, as well as a general understanding of the regulatory scheme?	_____	_____
3. In approving membership in a non-U.S. exchange or clearinghouse, do the board minutes evidence a discussion of the regulatory environment and any relevant credit, liquidity, and legal risks associated with doing business in a particular jurisdiction?	_____	_____
4. Does the FCM monitor the financial condition of each exchange and clearing organization for which it is a member?	_____	_____
3250.0.11.9 Market Risk		
1. If an FCM engages in proprietary trading, are policies and procedures in place to control potential conflicts of interest between its brokerage business and trading activities?	_____	_____
2. If an FCM has entered or plans to enter a foreign market, has the FCM performed due-diligence reviews of relevant legal and regulatory issues, as well as on local business practices?	_____	_____

	Yes	No
<b>3250.0.11.10 Liquidity Risk</b>		
1. Has the FCM established and does it monitor daily settlement limits for each customer to ensure liquidity sufficient to meet clearinghouse obligations?	_____	_____
2. Has the FCM established back-up liquidity facilities to meet unexpected shortfalls?	_____	_____
3. Does the FCM monitor the amount of open interest (concentrations) by product that it holds, directly or indirectly, at each exchange?	_____	_____
<b>3250.0.11.11 Reputation Risk</b>		
1. Is the FCM able to assess the extent of any material exposure to legal or reputation risk arising from its activities?	_____	_____
2. Does the parent company receive sufficient information from the FCM's information systems to assess the extent of any material exposure to litigation or reputation risk arising from the FCM's activities?	_____	_____
3. If the FCM provides investment advice to customers or commodity pools, does it have procedures designed to minimize the risks associated with advisory activities?	_____	_____
4. If the FCM acts as a CPO, has it obtained prior Board approval and is it in compliance with any conditions in the Board order?	_____	_____
<b>3250.0.11.12 Internal Controls</b>		
1. Does the FCM have written procedures pertaining to the following:		
a. the types of futures and options on futures contracts which the FCM will execute?	_____	_____
b. individuals authorized to effect transactions and sign contracts and confirmations?	_____	_____
c. the firms or individuals with whom FCM employees may conduct business?	_____	_____
2. Does the FCM obtain written authorization from customers specifying the individuals who are authorized to execute trades on behalf of the customers?	_____	_____
3. Does the FCM have written procedures governing—		
a. the solicitation and acceptance of customers?	_____	_____
b. the execution of purchases and sales?	_____	_____
c. processing transactions?	_____	_____
d. accounting for transactions?	_____	_____
e. clearing of transactions?	_____	_____
f. safekeeping of customer margin deposits or securities deposited as margin?	_____	_____
4. Does the FCM have written contracts with all firms or individuals who may conduct business on behalf of the FCM?	_____	_____
5. Does the FCM have proper segregation of duties to ensure that individuals involved in executing transactions are not able to make accounting entries?	_____	_____
6. Does the FCM have a numbered and controlled system of order tickets and confirmations to prevent unauthorized trading and to verify the accuracy of records and enable reconciliation throughout the system?	_____	_____

	Yes	No
7. Does the FCM have procedures to time stamp receipt of all orders at least to the nearest minute and execute all orders strictly in chronological sequence (to the extent consistent with the customers' specifications)?	_____	_____
8. Does the FCM have a system for routing incoming confirmations to an operating unit separate from the unit that executes transactions?	_____	_____
9. Does the FCM have a system for comparing internal and external confirmations to ensure that the FCM will not accept or deliver securities and/or margin payments without proper authorization and documentation?	_____	_____
10. Does the FCM have procedures to ensure that someone outside the trading unit is responsible for resolution of trades in which incoming and outgoing confirmations do not match?	_____	_____
11. With respect to transactions cleared by others, are procedures in place for verifying and agreeing clearing FCM open position and margin deposit reports?	_____	_____
12. Does the FCM review daily outstanding contracts, customer positions, and margin balances?	_____	_____
13. Does FCM management regularly review all adjustments affecting futures positions or income recognition to verify that such adjustments were proper and approved?	_____	_____
14. Are subsidiary ledgers regularly reconciled to the general ledger?	_____	_____
15. Has the FCM adopted written supervisory procedures for supervising brokers and others to ensure that they follow written policies and procedures?	_____	_____
16. Are there written procedures containing criteria for selecting and training competent personnel?	_____	_____
17. Does the FCM have a comprehensive reporting system for providing management with all the information necessary to effectively manage the FCM's operations?	_____	_____
18. Are procedures in place to ensure that any futures advisory services (investment advice) furnished—		
a. reflect the views of persons authorized to supervise advisory activities?	_____	_____
b. are authorized under Regulation Y or by Board order?	_____	_____
19. Is there a formal and comprehensive internal audit program pertaining to FCM activities?	_____	_____

## 3250.0.12 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

<i>Subject</i>	<i>Laws<sup>1</sup></i>	<i>Regulations<sup>2</sup></i>	<i>Interpretations<sup>3</sup></i>	<i>Orders</i>
Brokerage of gold and silver bullion and coins (provided subsequent basis for FCM execution and clearance of futures contracts)				38 <i>Federal Register</i> 27,552 (1973)
FCMs for the execution of futures contracts for gold, silver, platinum bullion, and coins				1990 FRB 552 1985 FRB 467 1977 FRB 951
FCMs for the execution and clearance of futures contracts				1982 FRB 651 1982 FRB 514
Engage in FCM activities: U.S. government securities, negotiable money market instruments, foreign exchange				1983 FRB 729 1983 FRB 216
FCM engaged in the execution and clearance of options				1983 FRB 733
Inclusion into Regulation Y permissible nonbanking activities (1984 and 1987)		225.28(b)(7)(iv)		1984 FRB 53 1984 FRB 591
Execution and clearing of futures contracts on a municipal bond index and to provide futures advisory services				1986 FRB 144 1985 FRB 803 1985 FRB 651 1985 FRB 111
Execute, purchase, and sale of gold and silver bullion and coins for the account of customers				1985 FRB 467 1985 FRB 251 1985 FRB 111
Advisory services for futures contracts on stock indexes and options thereon				1987 FRB 220
Advice on certain futures and options on futures				1988 FRB 820
Execution and clearance of futures contracts on stock indexes, options thereon, and futures contracts on a municipal bond index				1985 FRB 970
Execution and clearing futures contracts on stock indexes				1985 FRB 801
Providing investment advice on financial futures and options on futures		225.28(b)(6)(iv) (Regulation Y)		1997 FRB 275 1986 FRB 833

<i>Subject</i>	<i>Laws<sup>1</sup></i>	<i>Regulations<sup>2</sup></i>	<i>Interpretations<sup>3</sup></i>	<i>Orders</i>
Providing investment advice on trading futures contracts and options on futures contracts in nonfinancial commodities				1991 FRB 126
Executing-only and clearing-only trades				1993 FRB 728 1993 FRB 723
Discretionary portfolio management services on futures and options on futures on financial commodities				1995 FRB 386
Discretionary portfolio management services on futures and options on futures on nonfinancial commodities				1995 FRB 803
FCM executing and clearing, and clearing without execution, futures and options on futures on nonfinancial commodities				1993 FRB 1049
Trading for one's own account in futures, options, and options on futures contracts based on certificates of deposit or other money market instruments				1995 FRB 190
Commodity and index swap transactions—originator, principal, agent, broker, or adviser				1995 FRB 191 1995 FRB 190
Trading in futures options on futures contracts based on commodities or on stock, bond, or commodity indexes for one's own account				1995 FRB 185
Discretionary portfolio management services on futures and options on futures on financial commodities				1995 FRB 386 1994 FRB 151
FCM execution, clearance, and advisory services for contracts on financial and nonfinancial commodities for noninstitutional customers				1995 FRB 880
Serving as a commodity pool operator				1996 FRB 569

<i>Subject</i>	<i>Laws<sup>1</sup></i>	<i>Regulations<sup>2</sup></i>	<i>Interpretations<sup>3</sup></i>	<i>Orders</i>
Primary clearing firm for a limited number of floor traders and brokerage services for forward contracts on financial and nonfinancial commodities				1997 FRB 138

1. 12 U.S.C., unless specifically stated otherwise.

2. 12 C.F.R., unless specifically stated otherwise.

3. Federal Reserve Regulatory Service reference.

# 4(c)(8)—Agency Transactional Services (Futures Commission Merchant Board Orders) Section 3251.0

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This section serves as a prelude to the futures commission merchant activities (FCM) that are provided as examples of previous Board FCM decisions. Sections 3251.0.1 through 3251.0.13 provide brief historical summaries of Board decisions that may have led to the authorizations that have been incorporated into the April 1997 revision of Regulation Y for this activity. The summaries provide the reader with some historical perspective as to how and why the current provisions of Regulation Y evolved for FCMs. Certain conditions and commitments within these orders may no longer apply to the current provisions of Regulation Y. Therefore, reference must be made to the current Regulation Y, section 225.28(b)(7)(iv).

## 3251.0.1 FCM BROKERAGE OF FUTURES CONTRACTS ON A MUNICIPAL BOND INDEX

A bank holding company applied pursuant to section 4(c)(8) of the BHC Act and section 225.23(a)(3) of Regulation Y to engage de novo, through a wholly owned subsidiary located in the state of New York, to execute and clear futures contracts on a municipal bond index. The applicant also proposed to offer futures advisory services for a separate fee or as an integrated package of services to futures commission merchant customers through the subsidiary.

The Board had previously approved by regulation the activity of executing and clearing futures contracts on bullion, foreign exchange, U.S. government securities, and money market instruments, primarily on the basis that banks may hold and deal in the underlying cash items. The proposed futures contract on a municipal bond index was based on an index of general obligation bonds selected by the *The Bond Buyer*. The Bond Buyer Municipal Index is composed of 50 tax-exempt municipal revenue and general obligation bonds chosen on the basis of criteria that favor recently issued and actively traded bonds. The index is intended to be an accurate indicator of trends and changes in the municipal bond market. The offering of futures contracts based on the bond index (broad spectrum of municipal securities) could provide FCM customers with a more effective tool for hedging against the price risk associated with a portfolio of municipal bonds than any of the existing interest-rate futures contracts.

Banks are permitted to hold and deal in general obligation bonds, and they are active participants in the cash markets for those bonds. Based on these facts, the Board determined that the applicant's proposal was substantially similar to proposals to broker other financial futures previously approved by the Board, and was thus closely related to banking.

With regard to the proposed advisory activities, the Board had previously approved by order the provision of advisory services relating to approved FCM activities (1984 FRB 780). The applicant proposed to provide advisory services either for a separate fee or as an integral package of services to FCM customers. The services would include written or oral presentations on the historical relationship between the cash and futures markets, a demonstration of examples of financial futures uses for hedging, and assistance in structuring a hedging strategy. The applicant would provide these services only to major corporations and other financial institutions.

Based on all the facts provided, the Board concluded that—

1. the proposed activities by the applicant could reasonably be expected to produce benefits to the public;
2. the proposed FCM activities would entail risks or conflicts of interests different than those considered and addressed by the Board in its approvals of other FCM activities; and
3. the balance of the public-interest factors was favorable.

The Board noted, however, that trading of the futures contract involved in the application had not been approved by the Commodity Futures Trading Commission (CFTC). It therefore conditioned its December 21, 1984, approval of the application on the CFTC's approval of the contract (1985 FRB 111).

## 3251.0.2 FCM BROKERAGE OF CERTAIN FUTURES CONTRACTS ON STOCK INDEXES INCLUDING OPTIONS

A bank holding company applied, under section 4(c)(8) of the BHC Act and section 225.21(a) of Regulation Y, to engage, de novo through its

wholly owned futures corporation, in executing and clearing, on major commodity exchanges, futures contracts on stock indexes and options on such futures contracts. The subsidiary would execute and clear—

1. the Standard & Poor's 100 Stock Price Index futures contract;
2. the Standard & Poor's 500 Stock Price Index futures contract (S&P 500);
3. options on the S&P 500, all of which are traded on the Index and Option Division of the Chicago Mercantile Exchange;
4. the Major Market Index futures contract, currently traded on the Chicago Board of Trade; and
5. the FT-SE 100 Equity Index futures contract, currently traded on the London International Financed Futures Exchange.

The execution and clearance of stock index futures and options traded on major commodity exchanges appeared to be functionally and operationally similar to securities brokerage, permitted for bank holding companies under section 225.28(b)(6)(i) of Regulation Y. Like municipal bond index futures (an activity proposed by an applicant which was previously approved by Board order), these futures contracts are settled in cash and are designed to allow customers to hedge the market risk associated with holding financial assets, in this instance, corporate equity securities. The equities represented by the listed indexes were chosen on the basis of criteria that favor a combination of securities that would accurately reflect fluctuations in the stock market.

The Board approved the application on February 4, 1985, based on the above analysis and on the fact that national banks have been permitted to execute and clear stock index futures, and options thereon, for the account of customers, through their FCM operations subsidiaries (1985 FRB 251). It also took into consideration the fact that trust departments of banks have begun to use stock index futures contracts and options on such contracts to hedge the market risk facing diversified stock portfolios.

for the Board's permission under section 4(c)(8) of the BHC Act and section 225.23(a)(3) of Regulation Y to engage de novo in various FCM activities. The activities were to be conducted through its wholly owned FCM subsidiary (the company). The FCM activities consisted of—

1. executing and clearing, executing without clearing, and clearing without executing, as agent for institutional customers, the futures contracts and options on futures contracts listed in appendix A of the order;
2. executing and clearing as agent for institutional customers, through omnibus trading accounts with unaffiliated FCMs, the futures contracts and options on futures contracts listed in appendix B of the order; and
3. providing related investment advisory services.

The applicant proposed to conduct the activities throughout the United States.

The applicant requested authority to conduct, through the company, both execution and clearing activities on the Chicago Mercantile Exchange (CME) and the Chicago Board of Trade (CBOT). The company also planned to conduct FCM activities through omnibus customer trading accounts established in its own name with clearing members of the exchanges on which the company would not be a member.<sup>1</sup>

The applicant also sought authority for the company to clear trades on the CME and the CBOT that had been executed by unaffiliated brokers pursuant to "give-up agreements." Under the applicant's proposal, the company would not be the primary clearing member for any nonclearing member on the CBOT and would not qualify any nonclearing member on the CME. The company also planned to execute trades that would be given up for clearance, at the customer's request, to an unaffiliated FCM.

The Board had previously determined, by regulation and order, that acting as an FCM in executing and clearing all of the proposed financial futures contracts and options on futures contracts, and providing investment advisory services with respect to such contracts, are activities closely related to banking under sec-

### 3251.0.3 LIMITED FCM CLEARING-ONLY AND EXECUTING-ONLY TRADES

A bank holding company (the applicant) applied

1. An omnibus account is an arrangement between a member clearing firm of an exchange and a nonmember FCM that seeks to conduct business on that exchange. Using this arrangement, the member clearing firm executes and clears transactions for the nonmember FCM and its customers. The omnibus account reflects all positions of the FCM's customers but is divided into separate segments for each customer for the purposes of calculating margin requirements, reporting current holdings, and other matters.

tion 4(c)(8) of the BHC Act with two exceptions.<sup>2</sup> See section 225.28(b)(7)(iv) and (b)(6)(iv) of Regulation Y and the Board orders found at 1992 FRB 953, 1991 FRB 64, 1990 FRB 881, and 1990 FRB 554.

On January 9, 1991, the Board denied a bank holding company's application to engage, through a nonbanking subsidiary, in clearing-only activities related to securities options and other financial instruments. The applicant in that case had proposed that its subsidiary primarily clear, but not execute, trades for professional floor traders (primarily market makers and specialists) trading for their own accounts on major securities and commodities exchanges. (See section 3700.12 and 1991 FRB 189.)

In the 1991 case, the Board was concerned that, by not engaging in both the execution and clearance of a trade, the nonbanking subsidiary could not decline transactions that posed unacceptable risk. It would have been obligated to settle each trade entered into by one of its customers, even if the customer did not have the financial resources to honor the obligation. No mechanism existed by which the nonbanking subsidiary could contemporaneously monitor the intra-day trading activities of the floor traders, its primary customers. The Board decided that the proposed nonbanking activity exposed the parent bank holding company to substantial credit risk. This decision was based on (1) the subsidiary's inability to monitor and control the risks to be undertaken and (2) the fact that clearing agents had to guarantee the financial performance of their customers to the clearing-houses of the exchanges on which they operate. The public-benefit considerations therefore precluded approval of that application under section 4(c)(8) of the BHC Act.

The applicant's proposal differed from the 1991 case in several respects. Under the proposal, the company would not serve as the primary or qualifying clearing firm for any unaffiliated customers. Also, the company would clear only those trades that it executed, or that other executing brokers executed and the company accepted for clearance pursuant to a customer's give-up agreement. The executing brokers would be independent from the customers and would

have the opportunity to evaluate the trade before it was executed.

All of the company's clearing-only activities would be conducted pursuant to give-up agreements. Under these give-up agreements and other customer agreements, the company would have the right to refuse to accept for clearance any customer trade that it deemed unsuitable. The refusal could stem, for example, from consideration of market conditions or the customer's financial situation or objectives. Also, the applicant represented that it would be able to restrict the number and types of positions to be held by a customer as it deemed reasonable. The company could then refuse to accept trades that posed unacceptable risks.

The company established a framework for limiting risk from the clearing-only activities. It would review the creditworthiness of each potential customer and, based on the review, approve or reject the customer and establish appropriate limits concerning trading, margin, credit, and exposure limits. The company had controls in place to monitor the intra-day trading activities and risk exposure of its customers.

The Board determined that the credit and other risk considerations associated with the proposed clearing-only activities on the CME and CBOT were consistent with previous approvals. The decision was based on (1) the framework for limiting risk from clearing-only activities, (2) the commitments made by the applicant, and (3) the other facts of record. After reviewing other required considerations, the Board approved the application on May 6, 1993 (1993 FRB 723). Approval was subject to the commitments made by the applicant and the terms and conditions set forth in the order as well as in other Board orders related to the proposed activities.

### 3251.0.4 FCM CLEARING TRANSACTIONS BY PREAPPROVED EXECUTION GROUPS

A foreign banking organization (the applicant) subject to the provisions of the BHC Act applied for the Board's permission under section 4(c)(8) of the BHC Act and section 225.23(a) of Regulation Y to engage de novo in clearing trades of sophisticated institutional investors relating to contracts on futures and options on futures. Trades would be cleared through the applicant's majority-owned clearing subsidiary (the com-

2. The two exceptions are the Deutsche Aktienindex 30 Stock Index futures and the German Government Bond Index futures contracts traded on the Deutsche Terminborse GmbH. These two contracts had been approved as FCM activities pursuant to Regulation K. The Board also noted that these contracts served the same functions as the futures contracts for which FCM activities had previously been approved under section 4(c)(8) of the BHC Act.

pany) on the Chicago Mercantile Exchange (CME) and the Board of Trade of the City of Chicago (CBOT) and executed by nonaffiliated floor brokers.

In particular, the applicant proposed to accept for clearance customer orders that are executed by preapproved execution groups pursuant to “give-up agreements.”<sup>3</sup> The applicant expected that the company would initially provide only limited execution services. The company would not be the primary clearing firm for any non-clearing member of the CBOT, and would not qualify any nonclearing member of the CME.

The applicant also sought approval to engage in other FCM and data processing and transmission activities. The applicant committed that the company would conduct these activities according to the provisions and subject to the limitations of Regulation Y (section 225.28(b)(7)(iv) and (b)(14)).<sup>4</sup> The company also planned to engage in certain other activities that the applicant maintained were incidental to its FCM services. These activities included the management of institutional-customer funds under its control. The incidental activities would also include providing to institutional customers, on request, general advice about (1) sources of information, (2) the selection and arrangement of an appropriate execution group, (3) the availability of computer software relating to futures and options on futures, (4) order-placement alternatives, and (5) cost-reduction methods in the use of futures and options on futures for hedging purposes. The company committed that it would not provide investment advice relating to futures and options on futures or on any other matter not authorized by the order.

The Board previously denied a proposal in which a nonbanking subsidiary of a BHC would have cleared, but not executed, trades for professional floor traders (primarily market makers and specialists) trading for their own account on

major securities and commodity exchanges. (See 1991 FRB 189 and section 3700.12.) In that order, the Board was concerned that, by not engaging in both the execution and clearance of a trade, the FCM nonbanking subsidiary could not decline transactions that posed unacceptable risk. It would have been obligated to settle each trade entered into by one of its customers, even if the customer did not have the financial resources to honor the obligation. No mechanism existed by which the FCM nonbanking subsidiary could contemporaneously monitor the intra-day trading activities of the floor traders, its primary customers. The Board decided that the proposed nonbanking activity exposed the parent bank holding company to substantial credit risk. This decision was based on (1) the FCM’s inability to monitor and control the risks to be undertaken and (2) the fact that the clearing agents had to guarantee the financial performance of their customers to the clearinghouses of the exchanges on which they operate. The public-benefit considerations therefore precluded approval of that application under section 4(c)(8) of the BHC Act.

The applicant’s proposal differed from the above-mentioned denied application in various respects. In the applicant’s case, the company would not serve as the primary or qualifying clearing firm for any broker that executes its clearing-only trades or for any nonaffiliated customer. The company would clear only trades that it executes, or that other executing brokers execute and the company accepts for clearance pursuant to the customer’s give-up agreement.

The applicant represented that, under the give-up agreements, the company would have the contractual right to refuse a customer’s trade that exceeded established trading limits that were documented in the give-up agreement for that particular customer. The company would have a period of time within which it could determine if the executed trade was properly authorized according to established limits, and could decide to reject the trade.

The company’s customer base would consist of sophisticated institutional investors. The company would review the creditworthiness and other characteristics of each potential customer. Based on that review, it would approve or reject the customer and establish appropriate trading, credit, margin, and exposure limits for the customer. It would accept for clearance only trades that had been executed by preapproved execution groups trading on the CBOT and CME. Company would approve an execution group only if the floor brokers, and their primary or qualifying clearing firms, satisfied the com-

3. Under a give-up agreement, the executing floor broker (or give-in broker), pursuant to a customer’s instructions, gives up an executed order for clearance to a clearing member other than the executing broker’s primary clearing member (or qualifying member). Such agreements are used primarily to allow institutional customers to select a broker who has superior expertise and execution skills with respect to specific contracts or types of orders, while maintaining their accounts and positions with a clearing firm in which they have financial confidence.

4. Company would not trade for its own account except (1) to hedge a cash position in the related financial instrument or (2) to offset or liquidate a clearing error arising in the normal course of business.

pany's financial, managerial, and operational standards.

The Board decided that the credit and the other risk considerations associated with the proposed nonbanking activities were consistent with requirements for approval. The decision was based on (1) the framework described in the order; (2) the fact that the company would not be the primary or qualifying clearing firm for any broker that executed the company's clearing-only trades, or for any nonaffiliated customer; (3) the other contractual and operational distinctions noted between this proposal and the previous denied application (1991 FRB 189); and (4) the other facts of record.

The Board noted that it had recently approved applications by two bank-affiliated FCMs to engage in clearing-only activities, also on the CBOT and the CME (1993 FRB 723 and 1993 FRB 728). For a brief summary of the initial order, see section 3251.0.3.

The Board approved the application on August 2, 1993 (1993 FRB 961). The approval was subject to the facts of record, all the commitments made by the applicant, and the limitations and conditions stated in the order.

### 3251.0.5 FCM—EXECUTING AND CLEARING, AND CLEARING WITHOUT EXECUTING, FUTURES AND OPTIONS ON FUTURES ON NONFINANCIAL COMMODITIES

A bank holding company (the applicant, a BHC within the meaning of the BHC Act) applied for the Board's permission under section 4(c)(8) of the BHC Act and section 225.3 of the Board's Regulation Y to act, through a wholly owned subsidiary (the company), as a futures commission merchant (FCM) for unaffiliated customers in executing and clearing, and clearing without executing, futures and options on futures on *nonfinancial commodities*. Initially, the applicant proposed to conduct these activities in futures and options on futures on heating oil, crude oil, corn, wheat, soybeans, cattle, and hogs. The applicant must give at least 20 days' written notice to the Federal Reserve before it engages in FCM activities with respect to additional contracts linked to other physical commodities, unless other contracts are approved for any other bank holding company under the BHC Act.

The company is engaged in executing and clearing on major commodities exchanges futures and options on futures on financial commodities and certain broad-based and widely traded

stock and bond indices.<sup>5</sup> The company proposed to engage in its proposed activities on the CBOT, CME, and New York Mercantile Exchange (NYMEX).

The company *will not* trade in the proposed derivative instruments for its own account. However, when a customer defaults on a contract after the termination of futures trading and the company is required to make or take delivery of the underlying commodity, or when it exercises its right to liquidate a customer's account, the company is permitted to take the necessary actions to mitigate its damages. These actions include acting for its own account in retendering or redelivering the commodity, entering into an exchange-for-physical transaction, or entering into an offsetting transaction in the cash market, provided these and other appropriate actions are taken as soon as practicable.

The company will limit its proposed services only to institutional customers and will not provide such services to retain brokerage customers, locals, or market makers. Approximately 10 percent of its business will be conducted on behalf of managed commodity funds (regulated by the Commodity Futures Trading Commission (CFTC) and the National Futures Commission). None of the managed funds would be owned, sponsored, advised by, or otherwise affiliated with the applicant. The company will not act as a commodity trading advisor,<sup>6</sup> or otherwise provide investment advice on the proposed instruments.

The Board had not previously approved the execution and clearance by bank holding companies of futures and options on futures on nonfinancial commodities. The Board's approval had been limited to acting as an FCM in the execution and clearance on major commodities exchanges of futures and options on futures on a variety of financial commodities, such as gold

5. See 1985 FRB 970. The company already engages in FCM activities on the Chicago Mercantile Exchange (CME), Chicago Board of Trade (CBOT), Commodity Exchange, London International Financial Futures and Options Exchange, Marche a Terme International de France, and Singapore International Monetary Exchange.

6. As defined in the Commodity Exchange Act, a commodity trading advisor includes, with certain exceptions, "any person who, for compensation or profit, engages in the business of advising others, either directly or through publications or writings, as to the value of commodities or as to the advisability of trading in any commodity for future delivery on or subject to the rules of any contract market, or who for compensation or profit, and as part of the regular business, issues or promulgates analyses or reports concerning commodities." (7 U.S.C. 2)

and silver bullion and coins, foreign exchange, government securities, certificates of deposit and money market instruments that banks may buy and sell for their own accounts, and stock and bond indices.<sup>7</sup>

### 3251.0.5.1 BHC's Execution and Clearance of Futures and Options on Futures on Nonfinancial Commodities

National banks engage in a broad range of FCM activities involving all types of exchange-traded futures and option contracts consisting of financial and nonfinancial commodities for the accounts of customers, and for their own accounts, for hedging purposes. The Office of the Comptroller of the Currency (OCC) reasoned that the clearing process for any futures contract or option on a futures contract involves essentially an extension of credit because, upon receiving an executed order from a customer, the clearing broker supplies its own credit in an order on behalf of the customer and then sends the order to the exchange clearing organization for settlement. The OCC also determined that the execution, clearance, and advisory services provided by an FCM to its customers are essentially the same whether or not the underlying commodities are financial or nonfinancial.

Some national banks act as an FCM in the execution and clearance of futures and options on futures on a broad array of financial and nonfinancial commodities. The state of New York Banking Department has also permitted several New York-chartered banks to engage, to a limited extent, in FCM activities involving derivative instruments on nonfinancial commodities.

The Board has previously authorized bank holding companies to conduct FCM activities involving numerous instruments based on financial commodities. The Board determined that acting as an FCM in connection with contracts involving nonfinancial commodities is opera-

tionally and functionally similar to conducting FCM activities with respect to derivative contracts involving financial commodities. In both instances, the FCM monitors customer credit risk and trading exposure; assesses and collects initial and maintenance margins from customers; and brokers, executes, and clears trades.

Acting as an FCM for derivative instruments involves functions, skills, risks, and expertise that are substantially similar to those associated with the execution and clearance of financial futures and option contracts that the Board previously approved. The mechanics of executing and clearing trades are operationally the same whether the commodity underlying the exchange-traded derivative instrument is financial or nonfinancial. The rules and regulations of the CFTC, as well as the rules, procedures, practices, capital requirements, and safeguards of the various commodities exchanges, govern both the execution and clearance of nonfinancial futures and options and the execution and clearance of financial futures and options.

In 1991, the Board permitted bank holding companies to provide investment advice on trading futures contracts and options on futures contracts in nonfinancial commodities, such as agricultural and energy commodities. (See 1991 FRB 126.) It concluded that (1) providing investment advice on investing in futures and options on nonfinancial commodities appeared to be the functional equivalent of providing advice on futures and options on futures on financial commodities and (2) exchange-traded futures and options on futures involving nonfinancial commodities were essentially financial instruments.

The Board concluded, based on an analysis of the range of FCM activities currently existing in banking (as summarized above and cited in the order), that the activity of acting as an FCM in the execution and clearance of futures and options on futures on nonfinancial commodities, as proposed by the applicant, is an activity that is closely related to banking for the purposes of the BHC Act.

### 3251.0.5.2 FCM's Execution and Clearance of Futures and Options on Futures on Nonfinancial Commodities

The Board noted that both the company and the commodities exchanges on which the proposed FCM activities would be conducted are subject to regulatory oversight by the CFTC. The company's trading and clearance activities would also be subject to regulation and review by the CFTC and the commodities exchanges. The

7. See section 225.28(b)(7)(iv) of Regulation Y (12 C.F.R. 225). See also 1985 FRB 251, 1985 FRB 111, 1977 FRB 951, and 38 *Federal Register* 27,552 (1973). The applicant's proposed clearing without execution activities were approved in 1993 (FRB 723–728). The company proposed to conduct its clearing-only activities subject to the same conditions and limitations set forth in these Board orders, including the use of the “give-up agreement” by and among the company, its customers, and the nonaffiliated executing FCM that allows the company to not clear trades that exceed specified risk parameters.

applicant committed to conduct the proposed activities subject to the same rules and procedures the Board imposed on FCM activities in derivatives of financial commodities, including prohibitions on extending credit to customers for the purpose of meeting margin requirements. The applicant committed to take several further steps in the event that one of the company's customers has an open position in a contract after futures trading is ceased, and the customer is not willing or is unable to make or take delivery. Based on the commitments made by the applicant for conducting the proposed activities, the limitations on the activities cited in the order, and all the facts on record, the Board approved the application on September 28, 1993, subject to all the terms and conditions set forth in the order and the noted Board regulations and orders that relate to the proposed activities. (See 1993 FRB 1049.)

#### **3251.0.6 FCM AND RELATED ADVISORY SERVICES FOR OPTIONS ON EUROTOP 100 INDEX FUTURES AND THE ONE-MONTH CANADIAN BANKER'S ACCEPTANCE FUTURES**

A foreign bank (the applicant) subject to the provisions of the BHC Act applied for the Board's permission under section 4(c)(8) of the BHC Act and section 225.23 of Regulation Y for its section 20 subsidiary (the company) to act as an FCM for and provide advisory services to nonaffiliated persons, in connection with the purchase and sale of futures and options on futures contracts that are based on bonds or other debt instruments; certain commodities; or stock, bond, or commodity indices. The applicant proposed contracts that were not previously considered by the Federal Reserve System: options on Eurotop 100 Index futures, to be traded on the Commodity Exchange, Inc. (Eurotop contracts), and the one-month Canadian Banker's Acceptance Futures, to be traded on the Montreal Exchange (banker's acceptance futures). These contracts are based on a financial instrument or a broad-based financial index and are comparable to contracts previously considered by the Federal Reserve System. They have essentially the same terms and serve the same functions as futures and options contracts for which FCM and related advisory services have been approved by the Board under section 4(c)(8) of the BHC Act. The Board concluded that the skills necessary to engage in providing FCM and futures advisory services are the same

as those used to provide such services with regard to previously approved contracts. The Board thus approved the applicant's provision of these FCM and related advisory services for these contracts by the company, concluding that the activity is closely related to banking within the meaning of section 4(c)(8) of the BHC Act. (See 1995 FRB 188–189.)

#### **3251.0.7 FCM TRADING FOR ITS OWN ACCOUNT IN FUTURES, OPTIONS, AND OPTIONS ON FUTURES CONTRACTS BASED ON CERTIFICATES OF DEPOSIT OR OTHER MONEY MARKET INSTRUMENTS**

A foreign bank (the applicant) subject to the provisions of the BHC Act applied for the Board's permission under section 4(c)(8) of the BHC Act and section 225.23 of Regulation Y for its section 20 subsidiary (the company) to trade as an FCM in all futures, options, and options on futures contracts based on certificates of deposit or other money market instruments that are permissible investments for national banks. The Board had previously authorized company to trade for its own account, for purposes other than hedging, in futures, options, and options on futures contracts based on U.S. government securities that are permissible investments for national banks and in similar contracts based on certain money market instruments. (See 1991 FRB 759.) In that order, the Board noted that trading in these contracts would require a market judgment on interest rates. It was noted that banks, through their core lending and funding activities, had developed expertise in judging interest-rate and price movements. For those reasons, and because that proposal would not authorize company to trade in derivative contracts based on securities or instruments that a state member bank could not purchase for its own account, the Board determined the trading activity to be closely related to banking under section 4(c)(8) of the BHC Act.

The Board concluded that its reasoning in the 1991 order could be applied currently to this expanded 1994 proposal. The Board noted that the Office of the Comptroller of the Currency had determined that trading in futures and options contracts based on bank-eligible securities or instruments is an activity that is within the

legally authorized powers of national banks (OCC Interpretive Letter No. 494 (December 20, 1989)). The Board thus concluded that the proposed trading activity is conducted by banks and is so operationally and functionally similar to activities conducted by banks that banks are particularly well-equipped to engage in the activity. It therefore concluded that trading for one's own account, for purposes other than hedging, in futures, options, and options on futures contracts based on certificates of deposit or other money market instruments that are permissible investments for national banks is an activity that is closely related to banking within the meaning of section 4(c)(8) of the BHC Act. (See 1995 FRB 190.)

### 3251.0.8 FCM ENGAGING IN COMMODITY AND INDEX SWAP TRANSACTIONS AS AN ORIGINATOR, PRINCIPAL, AGENT, BROKER, OR ADVISOR

A foreign bank (the applicant) subject to the provisions of the BHC Act applied for the Board's permission under section 4(c)(8) of the BHC Act and section 225.23 of Regulation Y for its section 20 subsidiary (the company) to engage in FCM activities and in acting as an originator, principal, agent, broker, or advisor with respect to swaps and swap-derivative products and over-the-counter option transactions based on certain commodities; stock, bond, or commodity indices; or a hybrid of interest rates and these commodities or indices (commodity and index swap transactions).<sup>8</sup> Except for certain advisory services, the Board had not determined whether these proposed activities are closely related to banking under section 4(c)(8) of the BHC Act. The Board had determined, by order or regulation, that acting as an originator, principal, broker, agent, or advisor with respect to interest-rate and currency swaps and swap-derivative products relating thereto (financial swap transactions) are activities closely related to banking and are thus permissible for bank holding companies. (See Regulation Y, section 225.28(b)(6) and 1993 FRB 345.)

The applicant anticipates that the section 20 subsidiary's swap transactions will be based on a variety of stock and bond indices, similar to those previously approved in connection with proposed FCM activities (or to a specially tailored basket of securities selected by the parties) (index transactions), or they could be based on precious metals and energy products or related commodity indices (commodity transactions). They also could include hybrid transactions that are based on a combination of interest rates and such indices or commodities.

Commodity and index swap transactions are operationally, structurally, and functionally similar to financial swap transactions. Both types of swaps involve privately negotiated financial transactions. The parties involved in the transaction agree to exchange specified payment streams over a specific period of time, based on a predetermined formula. For an interest-rate swap, the basic structure is an exchange between two counterparties of the payment streams that arise out of different interest payment obligations, calculated on the basis of an agreed-upon notional principal amount. With the commodity or index swap transaction, the parties exchange payment streams based on a notional principal amount and the prices of certain commodities or the value of or returns on certain securities or indices of securities, or on a combination of these and other measures such as interest rates. For both types of swap transactions, the parties enter into these contracts to meet various common investment objectives, including taking positions in the market for the underlying assets for investment purposes, limiting one's exposure to market uncertainties and future price fluctuations, and preserving principal while participating in the potential returns of a particular financial market or economic sector. Since a swap transaction is negotiated between parties, the economic terms of the transaction (including the duration of the contract; notional principal amount; method of calculating and frequency of payments; and underlying assets, rates, or indices upon which the payments are to be determined) can be individually tailored to meet specific financial goals and risk sensitivities of the counterparty.

National banks have been authorized by the OCC to engage in activities that involve matched and unmatched commodity and index swap transactions (including related swap-derivative products and over-the-counter options). The New York State Banking Department also approved these activities for state-chartered banks under its jurisdiction. In addition, the Board permits

8. The proposed activities are subject to the same commitments relating to interest-rate and currency swap transactions and related swap-derivative products. (See 1993 FRB 345.)

state member banks to enter into perfectly matched commodity and index swap transactions, provided the transactions are consistent with their state charters. Further, the Federal Reserve Bank of New York, acting under delegated authority, has approved proposals by state member banks to engage in such activities on an unmatched basis. (See 12 C.F.R. 208.128.)

For the foregoing reasons and based on the facts of record, the Board determined that engaging in commodity and index swap transactions is an activity conducted by banks. The Board also considered the similarities between these transactions and the financial swap transactions noted above, as well as the fact that banks and other intermediaries play a similar role in financial swap transactions and commodity and index swap transactions. It was noted that all of these contracts represent forms of financial intermediation that banks have historically engaged in. Based on all the facts on record, the Board concluded that these proposed activities are closely related to banking under section 4(c)(8) of the BHC Act.

As noted previously, the company also proposes to provide advisory, agency, and brokerage services with respect to commodity and index swap transactions. The Board believes that the authority of banks to conduct these activities could be implicit in or incidental to their authority to engage in the transactions as principal. In its analysis, the Board noted that banks can develop a familiarity and expertise as to the structure and economic effects of these transactions, which should well equip them to provide the intended advisory, agency, and brokerage services. National banks have been expressly authorized to provide advisory, execution, and other services with respect to exchange-traded futures and options on futures contracts based on financial and nonfinancial commodities. (See OCC Interpretive Letter No. 494.) The exchange-traded transactions are used for purposes similar to the over-the-counter transactions for which the applicant proposes that the company render advisory, agency, and brokerage services. The pricing bases for, economic effects of, and risk presented by the two types of transactions are also similar in important respects.

Based on the facts on record, the Board determined that the proposed advisory, agency, and brokerage services are activities conducted by banks or are operationally and functionally similar to such activities. Thus, they are closely related to banking under section 4(c)(8) of the BHC Act. (See 1995 FRB 190–191.)

### 3251.0.9 FCM TRADING IN FUTURES, OPTIONS, AND OPTIONS ON FUTURES CONTRACTS BASED ON COMMODITIES OR ON STOCK, BOND, OR COMMODITY INDICES FOR ITS OWN ACCOUNT

A foreign bank (the applicant) subject to the provisions of the BHC Act applied for the Board's permission under section 4(c)(8) of the BHC Act and section 225.23 of Regulation Y for its section 20 subsidiary (the company) to engage in *trading for its own account* for purposes other than hedging in futures, options, and options on futures contracts based on certain commodities or on stock, bond, or commodity indices—transactions that have not been expressly authorized for banks. The instruments to be traded are generally the same as those previously approved by the Board in considering FCM and futures advisory activities of bank holding company subsidiaries, such as crude oil futures, Standard & Poor's 500 Stock Price Index futures, and municipal bond index futures. (See 1993 FRB 1,049 and 1994 FRB 151 and also SR-93-27 (refer to Appendix A).) The applicant proposes to engage in FCM activities and go beyond furnishing those FCM and related advisory services and seeks the Board's permission for the company to trade these instruments for its own account. Such activities include arbitrage operations, market making for customer-accommodation purposes, and proprietary trading (taking positions for investment purposes), as well as hedging transactions.

The proposed activities could consist of exchange-traded instruments that could be based on commodities such as crude oil, providing for delivery of the underlying commodity upon expiration of the contract. The applicant confirmed that it does not intend to take delivery of such commodities but plans to take several actions to avoid delivery of commodities other than precious metals. These actions include closing positions in expiring contracts during trading periods and engaging in exchange-for-physical transactions after trading closes. The Board stipulated, as a condition of approval, that the applicant could not take delivery of the commodities, except in unusual circumstances. Whenever delivery is taken, the applicant is required to notify the Federal Reserve System and divest itself of the commodity promptly. The Board views the contracts as financial instruments, despite the possibility that trading

in such contracts can result in the delivery and ownership of commodities that banking organizations are generally not permitted to hold. The Board also noted, with respect to the proposed exchange-traded transactions that are based on an index of securities or commodities, that (1) the transactions would be settled in cash and (2) they would not provide for the delivery of the underlying securities or commodities.

The Board had not previously approved this trading activity, with respect to the instruments proposed, for bank holding companies or their subsidiaries under section 4(c)(8) of the BHC Act. The Board has, however, authorized acting as an FCM and providing advisory services with respect to the instruments to be traded. The Board also approved similar trading with respect to instruments based on U.S. government securities and money market instruments. (See 1991 FRB 759.) With respect to section 20 nonbank subsidiaries, the Board has recognized the utility of trading in these instruments to hedge market exposure resulting from other trading activities, indicating that these bank holding company subsidiaries may engage in such risk-management transactions as a necessary incident to their underwriting and dealing activities. (See 1994 FRB 449.) No federal bank regulatory authority had expressly permitted banks to trade in the proposed instruments for their own accounts for purposes other than hedging.

The Board believes that the proposed trading activities are closely related to banking. It noted that banks engage in activities with respect to the instruments in question that are similar to or related to the proposed trading activities and that they engage in trading activities for the same purposes with respect to similar instruments, including exchange-traded contracts based on bank-eligible securities and instruments and over-the-counter transactions based on commodities and various indices.

The Board further noted that banking organizations have substantial experience with exchange-traded derivative transactions based on commodities or on commodity or securities indices. It also noted important similarities between the proposed instruments and transactions that have been authorized for banks for nonhedging purposes. Moreover, the Board believes that the risks inherent in the proposed trading activities are similar to those that are experienced by banks that engage in swaps and other permissible transactions; hence, the proposed transactions require analytical skills; risk-

management policies, procedures, and techniques; and computer and operations systems similar to those used by banks for engaging in those permissible transactions. Based on this reasoning, the Board determined the proposed activity to be closely related to banking under section 4(c)(8) of the BHC Act. The Board's December 23, 1994, approval is subject to all the facts of record, all the commitments made in connection with the application, and the conditions cited in the order. (See 1995 FRB 185.) These include adhering to future supervisory or examination policies and guidance issued by the Board for a banking organization's derivatives business, including policies or guidance with respect to customer transactions, trading and marketing practices and policies, and related systems and controls.

#### 3251.0.10 APPENDIX A— PREVIOUS PRIOR-APPROVAL REQUIREMENTS FOR BANK HOLDING COMPANIES PROPOSING TO ENGAGE IN FCM ACTIVITIES

In May 1993, the Board reduced the prior-approval requirements for bank holding companies proposing to engage in certain futures commission merchant (FCM) activities. (See SR-93-27.) First, the Board delegated to Reserve Banks its authority to approve proposals by bank holding companies to act as an FCM in executing and clearing any futures contract on a financial commodity or stock or bond index that the Board has previously approved, on any Board-approved exchange. The Board also delegated to Reserve Banks its authority to approve proposals by bank holding companies to act as an FCM or commodity trading advisor in providing investment advisory services for previously approved financial instruments.

In addition, the Board modified and, in certain cases, eliminated the prior-approval requirement for bank holding companies seeking to act as an FCM for additional financial instruments or to act as an FCM on additional exchanges in which the bank holding company already has Federal Reserve System approval to engage generally in FCM activities. Any bank holding company that had previously received approval to act as an FCM under either Board order or the former sections 225.25(b)(18) and (b)(19) of Regulation Y could act as an FCM subject to certain limitations and conditions. These requirements were replaced by the April 1997 Regulation Y revision at section 225.28(b)(7)(iv).

### 3251.0.10.1 Interpretation of Appendix A—Prior-Approval Requirements for BHCs and Edge Corporations Proposing to Engage in FCM Activities Abroad

The streamlined procedures for approving applications to engage in FCM activities (SR-93-27), with respect to any new instrument that has not previously been reviewed and approved by the Board, are also applicable to submissions required to engage in FCM activities on exchanges located outside the United States under section 211.5(d)(17) of Regulation K. As stated in the regulation, no application is required for engaging in FCM activities overseas on exchanges and with respect to financial instruments that the Board has previously approved, unless the activities are conducted in accordance with the standards set forth in section 225.28(b)(7)(iv). Prior approval must be obtained when an exchange requires members to guarantee or otherwise contract to cover losses suffered by other members (“mutual” exchanges). Acting as an FCM on a mutual exchange requires prior Board approval under section 211.5(d)(17)(ii) regardless of whether the exchange has been previously approved by the Board.

As with FCM procedures under Regulation Y, a bank holding company or other investor (as defined in Regulation K) may submit a notice to expand its FCM activities outside the United States according to the procedures in SR-93-27. Such notifications are processed in a similar manner, and the investor is informed that an application under Regulation K is required if an instrument not previously approved by the Board does not clearly meet the criteria set out in SR-93-27 or if financial or other considerations warrant further consideration. In addition, an application under Regulation K is required for any proposal to conduct FCM activities on an exchange that has not previously been approved by the Board. (See SR-95-14, March 1995.)

### 3251.0.11 PROVIDING DISCRETIONARY PORTFOLIO MANAGEMENT SERVICES ON FUTURES AND OPTIONS ON FUTURES ON FINANCIAL COMMODITIES

A foreign bank (the applicant), a bank holding company within the meaning of the BHC Act, applied under section 4(c)(8) of the act to engage through company in providing discretionary portfolio management services with respect to

exchange-traded futures and options on futures on financial commodities.<sup>9</sup> The provision of discretionary portfolio management services, with respect to futures and options on futures on financial commodities, had not been previously considered by the Board as to whether it is closely related to banking under section 4(c)(8) of the act.

In providing discretionary management services, company would manage customers’ accounts and purchase and sell in its sole discretion exchange-traded futures and options on futures on financial commodities for such accounts. Company would provide discretionary management services in combination with providing futures commission merchant (FCM) transactional services and would only provide such services to institutional customers.<sup>10</sup> Company would not act as a counterparty on customer transactions or trade these instruments for its own account. In addition, company would not purchase or sell over-the-counter contracts for accounts over which it exercises discretion.

The Board has permitted bank holding company FCMs and commodity trading advisors to provide investment advice with respect to futures and options on futures on financial and nonfinancial commodities. (See Regulation Y, section 225.28(b)(6) and 1994 FRB 151.) The bank holding company argued that discretionary management is a normal manner of providing investment advice to institutional customers. Indeed, the Board permits bank holding companies to act as discretionary portfolio managers as part of providing investment advisory and full-service brokerage services with respect to securities. (See Regulation Y, section 225.28(b)(6) and (b)(7)(i).) In addition, the Office of the Comptroller of the Currency permits national banks to engage in discretionary funds management with respect to futures and options on futures.<sup>11</sup>

The applicant also indicated that company would provide the proposed futures-related dis-

9. The bank holding company also proposed to engage in a variety of data processing, securities, futures, and foreign-exchange-related activities through company and another subsidiary. The Board previously has determined by order or regulation that these activities are closely related to banking. The bank holding company committed to conduct these activities in accordance with the conditions established by the Board in Regulation Y and prior orders.

10. Company would provide these services to commodity pools but would not become a commodity pool operator.

11. See OCC Interpretive Letter No. 494 (December 20, 1989).

cretionary portfolio management services in accordance with the limitations and conditions that would be imposed if company were providing portfolio management services in the securities context. In this regard, the applicant committed that company would only provide the proposed discretionary portfolio management services to institutional customers and only at the request of such customers.

The applicant also indicated that it would have a fiduciary relationship with all customers to whom it provides the proposed discretionary management services and has committed that company would comply with applicable law, including fiduciary principles. As one method of meeting its fiduciary obligations, the bank holding company committed that company would obtain the consent of customers before engaging, as principal or agent, in a transaction in which any affiliate of company acts as principal in futures or options on futures transactions on the customer's behalf. Company and its affiliates also agreed not to share any confidential information concerning their respective customers without the consent of the customer. In addition, the applicant stated that company would exercise its discretionary management authority only in purchasing and selling exchange-traded instruments. Therefore, concerns surrounding over-the-counter instruments, such as the potential for abuses due to the lack of price transparency, were not presented by the proposal.

For these reasons, the Board concluded that providing discretionary portfolio management services with respect to futures and options on futures on financial commodities is closely related to banking and a proper incident to banking for purposes of section 4(c)(8). The application was approved by the Board on February 9, 1995. (See 1995 FRB 386.)

### 3251.0.12 FCM EXECUTION, CLEARANCE, AND ADVISORY SERVICES FOR CONTRACTS ON FINANCIAL AND NONFINANCIAL COMMODITIES FOR NONINSTITUTIONAL CUSTOMERS

A foreign banking organization (the notificant) subject to the provisions of the Bank Holding Company Act (BHC Act) provided notice under section 4(c)(8) of the BHC Act (12 U.S.C. 1843(c)(8)) and section 225.23 of the Board's Regulation Y (12 C.F.R. 225.23) of its proposal

that its indirect U.S. subsidiary (the indirect subsidiary)<sup>12</sup> acquire certain assets and assume certain liabilities of a company.<sup>13</sup> The notificant would engage indirectly in FCM execution, clearance, and advisory activities with respect to futures and options on futures on financial and nonfinancial commodities<sup>14</sup> and in buying and selling foreign exchange in the spot, forward, and over-the-counter options markets on the order of investors as riskless principal.<sup>15</sup> The Board had previously determined by order and regulation that the above proposed activities are closely related to banking within the meaning of section 4 of the BHC Act.<sup>16</sup>

#### 3251.0.12.1 Providing FCM Services to Certain Sophisticated Noninstitutional Customers

First, the notificant proposed that the indirect subsidiary would provide FCM execution, clearance, and advisory services with respect to contracts on both financial and nonfinancial commodities to persons that do not qualify as institutional customers but who trade futures and options on futures solely to hedge risks arising from their business activities (noninstitutional commercial hedger customers), such as farmers. The Board has limited bank holding companies to providing nonfinancial-commodities-related FCM services only to institutional customers. Similarly, with respect to contracts on financial commodities, the Board

12. The indirect subsidiary is wholly owned by the notificant. The indirect subsidiary engages in various futures commission merchant, foreign-exchange, and securities-related activities. See 1994 FRB 646 and 649.

13. The acquired firm was a clearing member of certain financial and nonfinancial commodities exchanges. The FBO stated that the indirect subsidiary would become a clearing member of those exchanges. In addition, that subsidiary would provide FCM services with respect to two exchange-traded contracts that had not previously been approved by the Board (Heating Oil Crack Spread Options and Gasoline Crack Spread Options) and would purchase and sell through the use of omnibus account arrangements certain futures and options on futures on nonfinancial commodities traded on two other exchanges.

14. These activities include providing execution-only and clearing-only services to customers. See 1993 FRB 723 and 1994 FRB 151.

15. The indirect subsidiary would provide the proposed riskless-principal services only to institutional customers, except that it would provide such services to certain noninstitutional customers when they direct it to convert funds from one currency to another to trade futures and options on futures contracts. Foreign-exchange-related advisory services would not be provided to these noninstitutional customers.

16. See 12 C.F.R. 225.28(b)(7)(iv) and 225.28(b)(6) and 1990 FRB 649 (1990).

has not permitted bank holding companies to provide execution-only or clearing-only services to noninstitutional customers and only permits bank holding companies to provide advisory services to financially sophisticated customers that have significant dealings in the underlying commodities.<sup>17</sup>

The indirect subsidiary's noninstitutional commercial hedger customers would be engaged or would be affiliated with a commercial enterprise that is engaged in producing, manufacturing, processing, or merchandising products or in providing services that are related to the commodities underlying the futures and options on futures contracts in which the customers would trade. The noninstitutional commercial hedger customers would not be engaged in executing their own trades on the floor of any commodities exchanges. The notificant stated that the indirect subsidiary would require noninstitutional commercial hedger customers to state in writing that they would only engage in "bona fide hedging transactions," as defined by the Commodity Futures Trading Commission (CFTC).<sup>18</sup> In addition, an initial credit-review process will be established to determine whether a noninstitutional commercial hedger customer's proposed hedging activities are appropriate in light of the customer's net worth and business activities. The indirect subsidiary will not permit noninstitutional commercial hedger customers to trade in any commodities other than those that the customer would trade to hedge risks from its commercial activities, and it would establish a system to detect any unauthorized trading activities.

By limiting transactional services and advice to areas in which the customer has special expertise, the proposed limitations address the concern that the customer would rely unduly on the bank holding company's advice or that the customer would be unable to detect conflicts of interest or advice that is motivated by the bank holding company's self-interest. Moreover, the notificant will abide by all the other limitations designed to more specifically address the potential risks that may result from provid-

ing clearing-only and execution-only services to these customers.

### 3251.0.12.2 Foreign-Exchange Activities

Second, in connection with the proposal that the indirect subsidiary will buy and sell foreign exchange on the order of customers as riskless principal, the notificant proposed that the indirect subsidiary be permitted to purchase and sell foreign exchange for its own account for limited purposes while also providing foreign-exchange-related execution and advisory services.<sup>19</sup> In several limited circumstances, the Board has permitted a bank holding company to provide foreign-exchange-related transactional and advisory services in a subsidiary that purchases and sells foreign exchange for its own account.<sup>20</sup> For example, the Board has permitted bank holding companies to provide foreign-exchange-related advice and transactional services through a subsidiary engaged in purchasing and selling foreign exchange for its own account to hedge positions in permissible interest-rate or currency-swap transactions or to hedge risks arising from the permissible securities underwriting and dealing activities of the subsidiary.<sup>21</sup>

The indirect subsidiary will take positions in foreign exchange only as a means to hedge financial-statement translations of income for its foreign parent and as necessary for the payment of invoices denominated in foreign currencies. It would not enter into a foreign-exchange transaction for its own account with a customer if the customer is receiving foreign-exchange services relating to such transaction from this subsidiary. The notificant committed that the indirect subsidiary will observe the standards of care and conduct applicable to fiduciaries with respect to its foreign-exchange-related advisory activities and will provide foreign-exchange-related execution and advisory services only to institu-

17. See 1993 FRB 1049 and 12 C.F.R. 225.25(b)(19) (contracts on financial commodities). These limitations address concerns that, in futures transactions, unsophisticated customers may place undue reliance on investment advice received from a banking organization and may not be able to detect investment advice that is motivated by the advisor's self-interest. Similarly, in cases involving clearing-only transactions, the limitation helps address the added risk to the bank holding company that results from its more limited ability to review and reject trades that have been executed through another FCM.

18. See 17 C.F.R. 1.3(z).

19. The indirect subsidiary currently provides foreign-exchange-related execution and advisory services to its customers. In permitting bank holding companies to provide foreign-exchange execution and advisory services on a combined basis, the Board has relied on the representation that the subsidiary providing the foreign-exchange-related services would not purchase or sell foreign exchange for its own account.

20. The Board also previously has noted that in conducting foreign-exchange operations, commercial banks combine the functions of giving advice, executing transactions, and taking positions in foreign exchange.

21. See 1994 FRB 157 and 1993 FRB 892.

tional customers. The notificant also committed that the indirect subsidiary's personnel engaged in purchasing and selling foreign exchange for its own account will not have access to information about the foreign-exchange trading activities of customers and that customer representatives will not have access to information about the foreign-exchange activities of personnel engaged in purchasing and selling foreign exchange for the indirect subsidiary's own account.<sup>22</sup>

### 3251.0.12.3 Board's Decision on the Proposed FCM Activities

Based on the foregoing and all the facts of record, the Board approved the notification subject to all the terms and conditions set forth in the order and in the above-noted Board regulations and orders that relate to these activities. The Board's determination is subject to all the terms and conditions set forth in the Board's Regulation Y, including those in sections 225.7 and 225.23(b). The Board's decision is specifically conditioned on compliance with all the commitments made. The notice was approved on July 14, 1995 (see 1995 FRB 880).

### 3251.0.13 FCM SERVING AS A PRIMARY CLEARING FIRM FOR A LIMITED NUMBER OF FLOOR TRADERS AND BROKERAGE SERVICES FOR FORWARD CONTRACTS ON FINANCIAL AND NONFINANCIAL COMMODITIES

A foreign banking organization and its parent holding companies (the notifiants), bank holding companies within the meaning of the Bank Holding Company Act, requested the Board's

approval under section 4(c)(8) of the BHC Act (12 U.S.C. 1843(c)(8)) and section 225.23 of the Board's Regulation Y (12 C.F.R. 225.23) to acquire all the voting securities of a company (the company) and thereby engage in a wide range of nonbanking activities, including securities- and derivatives-related activities. The company and its principal subsidiary (the subcompany) engage worldwide in a wide range of investment advisory, securities underwriting, and futures-related activities. The notifiants proposed to merge the subcompany and the company into the notifiants' existing nonbank section 20 company (the section 20 company). The section 20 company would continue as a registered broker-dealer with the Securities and Exchange Commission under the Securities Exchange Act of 1934 and as a member of the National Association of Securities Dealers. The section 20 company would also become registered as a futures commission merchant (FCM) and a commodity trading advisor (CTA).<sup>23</sup>

The notifiants proposed to engage in a variety of FCM-related activities the Board previously had determined, by regulation or order, were so closely related to banking as to be proper incidents thereto within the meaning of section 4(c)(8) of the BHC Act. The proposed activities included engaging in execution-only, clearing-only, and omnibus account activities with respect to futures and options on futures based on financial and nonfinancial commodities, and providing discretionary portfolio management services with respect to futures and options on futures on financial and nonfinancial commodities.<sup>24</sup> (See 1997 FRB 138–142.) The section 20 company committed to providing these futures-related execution-only, clearing-only, and discretionary portfolio management services only to institutional customers and certain sophisticated noninstitutional commercial hedger customers.<sup>25</sup>

### 3251.0.13.1 Primary Clearing Firm for a Limited Number of Professional Floor Traders

The notifiants also proposed that the section 20

22. To address potential conflicts of interest in connection with providing the proposed foreign-exchange riskless-principal services, the notificant committed that the indirect subsidiary will disclose to each customer that receives advice relating to over-the-counter transactions in the foreign-exchange market that it may have an interest as a counterparty principal in the course of action ultimately chosen by the customer. Also, in any case in which the indirect subsidiary has an interest in a specific over-the-counter foreign-exchange transaction as counterparty principal, it will advise its customer of that fact before recommending participation in that transaction.

23. The subcompany was already registered as an FCM and CTA.

24. The notifiants committed that the section 20 company would provide these services in accordance with the limitations previously established by the Board. See 1993 FRB 723, 1993 FRB 1049, and 1994 FRB 151.

25. The notifiants stated that all noninstitutional commercial hedger customers would meet the requirements previously reviewed by the Board. See 1995 FRB 880.

company provide clearing-only services to, and serve as the primary clearing firm for, certain professional floor traders on two exchanges with respect to the futures contracts and options on futures contracts traded on such exchanges.<sup>26</sup> The Board previously has determined that providing clearing services with respect to exchange-traded securities, options, futures, and options on futures contracts is closely related to banking within the meaning of section 4(c)(8) of the BHC Act. In 1991, however, the Board denied an application by the notificants to engage *de novo* in providing the proposed services to an unlimited number of market makers and other professional floor traders dealing for their own accounts.<sup>27</sup>

In the 1991 order, the Board recognized that a company serving as the primary clearing firm for professional floor traders may be exposed to significant financial risks because the company generally would not have the ability to reject an executed trade presented to it for clearance, even when the company believes the trade presents unacceptable risks in light of market conditions or the traders' financial position. The Board also noted that, at the time of the 1991 application, the applicants lacked appropriate operational systems to track and manage the intraday risks arising from the trading activities of the floor traders. This lack of a mechanism to monitor intraday trading activities presented the possibility that a professional floor trader could incur substantial losses through the trading of options or futures contracts, which the applicants would be obligated to clear and guarantee, before the applicants could act to mitigate their credit-risk exposure.

It was noted that since 1991, the Board and bank holding companies have gained substantial experience with the conduct, methods, procedures, and regulation of clearing-only activities. Also, since 1991, the Board had authorized bank holding companies to provide clearing-only services with respect to futures contracts and options on futures contracts for customers other than professional floor traders, subject to certain con-

ditions designed to ensure that the bank holding companies have the ability to manage the attendant financial risks.<sup>28</sup>

The Board concluded that the facts of record indicated that the subcompany had and the section 20 company would have sufficient risk-management policies, procedures, and systems to permit the notificants and the section 20 company to adequately monitor and control the risks, including the intraday risks, associated with the section 20 company's proposal to serve as the primary clearing firm for a limited number of professional floor traders on the two exchanges. Specifically, the section 20 company would use the subcompany's established trading, credit, margin, and exposure limits for each professional floor trader for which the section 20 company serves as the primary clearing firm. Adherence to these limits is monitored on an intraday basis by experienced personnel who are physically present on the floor of the two exchanges. These personnel visually monitor the trading activities of floor traders on the exchanges and review trades submitted by the floor traders for clearance.<sup>29</sup> If an employee of the section 20 company determines that a floor trader is exceeding the limits it has established, or is otherwise engaged in questionable trading activities, the employee would have the ability

28. In particular, the bank holding companies agreed to provide the clearing-only services pursuant to "give-up" agreements, which provide the bank holding companies with the right to refuse to accept for clearance any customer trade that the bank holding company deems unsuitable in light of market conditions or the customer's financial situation or objective. In addition, the bank holding companies agreed to establish procedures to monitor the intraday trading activities and risk exposure of their clearing-only customers.

29. The Board recognizes that trades on the two relevant exchanges are not electronically submitted to the clearing firm or the exchange. Instead, trading cards for each trade are submitted by each professional floor trader to its clearing firm, which enters the trade into the exchange's clearing system. Both exchanges require that the subcompany collect the trading cards from each floor trader at least once during each half-hour period, thereby providing the subcompany personnel with an opportunity to review the intraday trading activities of floor traders. The rules of one exchange also require that the subcompany enter all collected trades into the exchange's on-line clearing system within 45 minutes of the end of the half-hour period during which the trades were collected. That exchange's on-line clearing system also permits the subcompany to monitor the trading activities of floor traders, both individually and in the aggregate, on an intraday basis, and allows the subcompany to identify any potentially unmatched trades. Although the other exchange does not operate an on-line clearing system, the subcompany personnel maintain tally sheets that are updated every 30 minutes and reflect all trades submitted by each professional floor trader throughout the day.

26. A primary clearing firm is obligated to accept and clear all trades submitted by a professional floor trader, even if the trade was initially presented to, and rejected by, another clearing firm. Once a primary clearing firm clears a trade for a professional floor trader, the firm becomes obligated to settle the trade in the event of a default by the professional floor trader. The company served as the primary clearing firm for professional floor traders on the two exchanges. The notificants requested authority for the section 20 company to act as the primary clearing firm for up to 20 professional floor traders on one exchange and 40 professional floor traders on the other.

27. See 1991 FRB 189.

to limit or halt the floor trader's activities, require the floor trader to post additional margin, partially or entirely liquidate the floor trader's positions, or immediately revoke the floor traders membership on the exchange.<sup>30</sup> The notificants' operations managers on the two exchanges also would personally guarantee the section 20 company against any losses that it may incur from serving as the primary clearing firm for floor traders on the exchanges, thereby providing such personnel with an incentive to closely monitor the trading activities of the floor traders. The notificants also stated that the section 20 company would install an on-line risk-management system that would provide its personnel with intraday data on the trading activities of the professional floor traders, and the ability to analyze its exposure to such trading activities on an intraday basis.

The Board noted that the type of risk-management systems necessary to appropriately manage the risks arising from a particular activity necessarily depends on the scope and nature of the proposed activity. In this regard, the Board noted that the section 20 company proposed to serve as the primary clearing firm for only a limited number of professional floor traders on two exchanges. These exchanges have relatively small trading areas and volumes, which permit personnel on the floors of the exchanges to monitor trading activity. The Board noted that the Federal Reserve Bank had conducted an on-site operational and managerial infrastructure review used by the subcompany to monitor and control the financial risks associated with its primary clearing activities on the two exchanges. Based on that review and other facts of record, the Board concluded that the subcompany had the managerial and operational resources and systems to adequately monitor and control the financial risks arising from its role as primary clearing firm on the two exchanges.

The Board also noted that approval of the proposal could reasonably be expected to produce public benefits. Specifically, the Board noted that the subcompany served as the primary clearing firm for a significant percentage of the professional floor traders on the two exchanges and that the notificants' proposal would permit the section 20 company to con-

tinue providing primary clearing services to such professional floor traders.

In light of all the facts of record, including the limited nature of the section 20 company's proposed clearing-only activities for professional floor traders, the commitments provided by the notificants, and the operational and managerial systems that the section 20 company will have in place to monitor and control the risks arising from the proposed activities, the Board concluded that the credit and other risk considerations associated with the proposed clearing-only activities for professional floor traders on the two exchanges are consistent with approval of this notice and that, therefore, the proposed activity is a proper incident to banking within the meaning of section 4(c)(8) of the BHC Act.

#### 3251.0.13.2 Brokerage Services with Respect to Forward Contracts Based on Certain Financial and Nonfinancial Commodities

The notificants also proposed that the section 20 company act as broker with respect to forward contracts based on certain financial and nonfinancial commodities. In this capacity, the company would assist customers in arranging forward contracts with third parties pursuant to which the customers would make (or receive) delivery of financial and nonfinancial commodities on a future date.<sup>31</sup> The section 20 company would act as a broker only with respect to forward contracts that are based on those financial and nonfinancial commodities that also serve as the basis for an exchange-traded futures contract.<sup>32</sup> The Board recognized that banking regulators had not expressly permitted banks to engage in the proposed activity.

Bank holding companies are permitted to act as a broker in the execution and clearance of futures contracts and options on futures contracts based on financial and nonfinancial commodities.<sup>33</sup> As noted above, the forward contracts that the section 20 company proposed to broker would be based on the same financial and nonfinancial commodities that underlie futures contracts that bank holding companies

30. The subcompany's risk-management personnel also electronically receive trade information from the two exchanges up to four times a day. Reports based on such data are prepared by risk-management personnel and reviewed daily.

31. Because the section 20 company will act only as a broker, the section 20 company will not itself be required to take physical delivery of the nonfinancial commodities underlying the forward contracts that it arranges under any circumstances.

32. Exchange-traded futures contracts may be based on a wide variety of commodities, including precious metals, oil, cocoa, or wool.

33. See 1993 FRB 1049.

are permitted to broker as an FCM. Bank holding companies also are permitted to broker forward contracts on foreign exchanges and arrange swap transactions that are based on nonfinancial commodities or indices of nonfinancial commodities.<sup>34</sup> Accordingly, based on these and other facts of record, the Board concluded that acting as a broker for forward contracts based on those financial and nonfinancial commodities

that underlie an exchange-traded futures contract is a permissible activity for bank holding companies under section 4(c)(8) of the BHC Act.

### 3251.0.13.3 Conclusion

Based on all the facts of record, the Board approved the notice subject to all the terms and conditions discussed in the order and in the section 20 orders, as modified by the modification orders. (See 1997 FRB 138.)

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34. See 1995 FRB 185.

## Section 4(c)(8) of the BHC Act—Agency Transactional Services for Customer Investments (Other Transactional Services)    Section 3255.0

With the adoption of the April 1997 revision to Regulation Y, the Board authorized certain types of other transactional services in section 225.28(b)(7)(v). Bank holding companies can provide to customers as *agent* transactional services with respect to swaps and similar transactions—

1. any transaction that is described in section 225.28(b)(8) of the regulation;
2. any transaction that is permissible for a state member bank; and
3. any other transaction involving a forward contract, option, futures, option on a futures or similar contract (whether traded on an exchange or not) relating to a commodity that is traded on an exchange.

Under this provision of the current rule, a bank holding company can provide transactional services for customers involving any derivative or foreign-exchange transaction that the bank holding company is permitted to conduct for its own account (item 1 above). A bank holding company may also act as a broker with respect to forward contracts based on a financial or nonfinancial commodity that also serves as the basis for an exchange-traded futures contract. This permits a bank holding company to act as agent in a forward contract that involves the same commodities and assessment of risk that underlie the permissible FCM activities of bank holding companies. This authority is not extended to forward contracts for the delayed sale of commercial products (such as automobiles, consumer products, etc.) or real estate.

Before the incorporation of the above transactions into the authority of Regulation Y, such activities had been previously approved individually by Board order. This section provides, as historical examples, summaries of such activities that were previously approved by Board order. Such orders led to the incorporation of the nonbanking activity into the April 1997 Regulation Y “laundry list.” The reader of these examples should only consider the current provisions for “other transactional services” as found in section 225.28(b)(7)(v) of Regulation Y. There should be no reliance on previous Board order commitments, supervisory policies, and interpretations that relate to this nonbanking activity that were in existence before April 21, 1997, unless such provisions remain. Certain former provisions or commitments may no longer be applicable.

### 3255.0.1 BROKERING OPTIONS ON SECURITIES ISSUED OR GUARANTEED BY THE U.S. GOVERNMENT AND ITS AGENCIES AND OPTIONS ON U.S. AND FOREIGN MONEY-MARKET INSTRUMENTS

A bank holding company applied for the Board’s approval under section 4(c)(8) and section 225.21(a) of the Board’s Regulation Y to engage *de novo*, through a wholly owned indirect subsidiary, in certain futures commission merchant and broker-dealer activities. One of the activities proposed for Board approval consisted of engaging in brokerage activities with respect to options on certain physicals, that is, securities issued or guaranteed by the U.S. government and its agencies and U.S. and foreign money-market instruments. The Board concluded that an option on a physical appears to serve the same function as other instruments in that it offers the investor a means to hedge portfolio risk. The Board had previously approved applications to engage in discount securities brokerage for retail customers with respect to corporate securities, and had added discount securities brokerage to the list of permissible nonbanking activities for bank holding companies generally. As a broker for options on physicals, it was stated that the indirect subsidiary would act solely as agent on behalf of nonaffiliated persons for the purchase and sale of options.<sup>1</sup> The services performed by a broker of options on the proposed securities appeared to be similar to those of other brokers. The Board thus concluded on December 8, 1983, that the proposal was closely related to banking (1984 FRB 238).

### 3255.0.2 BROKERING OPTIONS IN FOREIGN CURRENCY ON EXCHANGES REGULATED BY THE SEC

A BHC applied for the Board’s approval under section 4(c)(8) of the BHC Act and section 225.21(a) of the Board’s Regulation Y to engage

1. A broker of options on U.S. government and agency securities and options on money market instruments is a securities broker under the securities laws.

de novo, through a wholly owned subsidiary, in executing and clearing options in foreign currency. The Board referenced its approval to a previous order regarding the brokering of options on certain financial physicals (see subsection 3255.0.1 above). The Board concluded that its rationale for this prior action was equally applicable to the brokerage of options in foreign exchange. The Board noted that the applicant had been active in the cash and forward markets for foreign currency and had the expertise to provide the proposed services to customers. The Board concluded on March 19, 1984, that, in the manner proposed, the applicant's proposal to broker options in foreign currency was closely related to banking (1984 FRB 368).

In considering the potential for adverse effects, the Board took into account and relied on the regulatory framework established pursuant to law by the SEC for the trading of options. In addition, the Board noted that the applicant would not trade any of the options involved for its own account.

### 3255.0.3 EXECUTING AND CLEARING CFTC-REGULATED OPTIONS ON BULLION AND FOREIGN EXCHANGE ON AUTHORIZED COMMODITY EXCHANGES

A BHC applied for the Board's approval under section 4(c)(8) of the BHC Act and section 225.21(a) of the Board's Regulation Y to engage de novo through its wholly owned subsidiary in executing and clearing options. As part of that

request, the BHC requested the Board to approve the executing and clearing of CFTC-regulated options on bullion and foreign exchange on authorized commodity exchanges. In making a determination that the activity was closely related to banking, the Board noted—

1. that it previously determined the brokering of futures and options on futures in bullion and foreign exchange to be a permissible nonbanking activity under the former section 225.25(b)(18) of Regulation Y (currently section 225.28(b)(7)(iv));
2. that options on physicals serve essentially the same function as futures and options on futures; and
3. that the brokering of options on certain physicals, that is, U.S. government securities, money market instruments, and options on foreign currency regulated by the SEC, is closely related to banking (1984 FRB 368, see subsection 3255.0.2, above).

The Board determined that the proposed CFTC-regulated options on physicals are functionally and operationally comparable devices for hedging investment-portfolio risk. The Board also determined that the applicant's proposal was substantially similar to proposals to engage in options activities previously approved by the Board. It noted that the applicant had been active in the cash and forward markets for bullion and foreign currency and that it possessed the expertise to provide the proposed services to customers. The Board therefore concluded the activity to be closely related to banking and approved the application on June 5, 1984, in the manner proposed (1984 FRB 591).

# Section 4(c)(8) of the BHC Act—Investment Transactions as Principal

## Section 3260.0

Under Regulation Y, a bank holding company may engage in—

1. underwriting and dealing in government obligations and money market instruments (see section 3260.0.1),
2. investing and trading activities as principal, and
3. buying and selling bullion and related activities.

A bank holding company may engage or trade as principal in the following:

1. foreign exchange
2. forward contracts, options, futures, options on futures, swaps, and similar contracts, whether traded on an exchange or not, based on any rate, price, financial asset<sup>1</sup> or nonfinancial asset, or group of assets, other than a bank-ineligible security,<sup>2</sup> if—
  - a. the underlying asset is a permissible investment for state member banks,
  - b. the derivative contract requires cash settlement, or
  - c. the derivative contract allows for assignment, termination, or offset prior to delivery or expiration and the bank holding company makes every reasonable effort to avoid delivery
3. forward contracts, options,<sup>3</sup> futures, options on futures, swaps, and similar contracts, whether traded on exchanges or not, based on an index of a rate, a price, or the value of any financial asset, nonfinancial asset, or group of assets, if the contract requires cash settlement

The above three alternative conditions do *not* apply to derivative contracts based on an index, but they do apply to all other contracts.

1. A bank holding company is also authorized to buy, sell, and store gold, silver, copper, platinum, and palladium bullion, coins, bars, and rounds, and any other metal approved by the Board.

2. A bank-ineligible security is any security that a state member bank is not permitted to underwrite or deal in under 12 U.S.C. 24 and 335.

3. This does not include acting as a dealer in options based on indexes of bank-ineligible securities when the options are traded on securities exchanges. These options are securities for purposes of the federal securities laws and bank-ineligible securities for purposes of section 20 of the Glass-Steagall Act (12 U.S.C. 377). Also not included is acting as a dealer in any other instrument that is a bank-ineligible security for purposes of section 20. Bank holding companies, when authorized, may deal in these instruments in accordance with the Board's orders on dealing in bank-ineligible securities.

Following the adoption of the April 1997 revised Regulation Y, a bank holding company can continue to trade in foreign exchange and bank-eligible securities. Bank holding companies, however, are no longer required to have a separate subsidiary to provide advice to customers when engaging in trading activities as principal.

Bank holding companies are broadly permitted to invest as principal in derivatives on financial and nonfinancial commodities. A bank holding company may invest or trade as principal in a derivatives contract on a financial or nonfinancial commodity or an index or commodities, so long as any one of three conditions are met:

1. The underlying asset is a permissible investment for state member banks.
2. The derivative contract requires cash settlement.
3. The derivative contract allows for assignment, termination, or offset before expiration, and the bank holding company makes every reasonable effort to avoid delivery.

A bank holding company may trade as principal a derivatives contract on an index of rates, prices, or the value of any financial or nonfinancial asset or group of assets, so long as the contract requires cash settlement. This does not include acting as a dealer in options based on indexes of bank-ineligible securities when the options are traded on securities exchanges.

Bank holding companies continue to acquire companies engaged in, or engage through an existing subsidiary in, derivatives trading and investment activities that would be beyond the scope of investment or trading activities encompassed within the bank-servicing exemption.<sup>4</sup> Regulation Y includes proprietary trading activities to clarify the permissibility of this activity as a separate business activity.

A bank holding company may engage in buying and selling bullion and related activities. This consists of buying and storing bars, rounds, bullion, and coins of gold, silver, platinum, palladium, copper, and any other metal approved by the Board for the company's own account and the account of others, and providing incidental services such as arranging for the storage, safe custody, assaying, and shipment.

4. For example, *Swiss Bank Corporation*, 1995 FRB 185.

Before the incorporation of these transactions into the authority of Regulation Y, certain of these activities had been approved individually by Board order. This section provides, as historical examples, summaries of such activities that were previously approved by Board order. Such orders may have led to the incorporation of the nonbanking activity into the April 1997 Regulation Y “laundry list.” The reader of these examples should only consider the current regulatory provisions as currently found in section 225.28(b)(8) of Regulation Y. Only minimum reliance should be placed on previous Board order commitments, supervisory policies, and interpretations that relate to this nonbanking activity that were in existence before April 21, 1997, unless such provisions remain currently. Certain former provisions or commitments may no longer be applicable.

### 3260.0.1 UNDERWRITING AND DEALING IN GOVERNMENT OBLIGATIONS AND MONEY MARKET INSTRUMENTS

A bank holding company may engage in underwriting and dealing in obligations of the United States, general obligations of states and their political subdivisions, and other obligations that state member banks of the Federal Reserve System may be authorized to underwrite and deal in under 12 U.S.C. 24 and 355. This includes banker’s acceptances and certificates of deposit, under the same limitations as would be applicable if the activity were performed by the bank holding company’s subsidiary member banks or its subsidiary nonmember banks as if they were member banks. See Regulation Y, section 225.28(b)(8)(i) and section 3240.0.

### 3260.0.2 FOREIGN EXCHANGE

A bank holding company may engage as principal in foreign exchange. See Regulation Y, section 225.28(b)(8)(ii)(A).

### 3260.0.3 ENGAGING AS PRINCIPAL IN BANK-ELIGIBLE DERIVATIVES INVOLVING FINANCIAL ASSETS AND NONFINANCIAL ASSETS OR GROUPS OF ASSETS

A bank holding company may engage as principal in forward contracts, options, futures, options

on futures, swaps, and similar contracts, whether traded on exchanges or not, based on any rate, price, financial asset, nonfinancial asset, or group of assets, other than a bank-ineligible security. A financial asset includes gold, silver, platinum, palladium, copper, or any other metal approved by the Board. See Regulation Y, section 225.28(b)(8)(ii)(B).

#### 3260.0.3.1 Trading for a Company’s Own Account in Futures, Options, and Options on Futures Based on U.S. Government Securities and Certain Money Market Instruments

A foreign bank, subject to the provisions of the BHC Act, applied to the Board under section 4(c)(8) and section 225.23 of the Board’s Regulation Y to engage through a wholly owned subsidiary in trading activities for its own account. The trading included futures, options, and options on futures based on U.S. government securities that are permissible investments for national banks (bank-eligible securities) and certain money market instruments.<sup>5</sup>

The Board had previously determined that BHCs could purchase derivative instruments based on government securities for the purpose of reducing interest-rate exposure (see 12 C.F.R. 225.142, Statement of Policy Concerning Bank Holding Companies Engaging in Futures, Forward, and Option Contracts on U.S. Government and Agency Securities and Money Market Instruments). Previously, the Board approved applications to trade in derivative instruments based on foreign exchange for the company’s own account for other than hedging purposes (see 1989 FRB 217). Section 225.28(b)(7)(iv) and 225.28(b)(6)(iv) of Regulation Y details a BHC’s ability to act as futures commission merchant and to offer advice with regard to futures and options on futures on bank-eligible securities, respectively.

The purchasing and selling of derivative instruments which represent the right to purchase and sell bank-eligible securities is considered by the Board to be closely related to banking.<sup>6</sup> The experience gained by banks in dealing

5. See 1991 FRB 759 for a listing of the derivative instruments to be traded, which are listed in appendix A. The subsidiary would hedge its positions in these instruments with the instruments listed in appendix B of the order.

6. The applicant was not authorized to purchase derivative instruments based on securities or instruments that a state member bank may not purchase for its own account.

with the securities underlying these instruments would equip the banks to trade in instruments based on these securities. In addition, the derivative instruments based on money market instruments require a market judgment on interest rates. Banks have developed an expertise in such judgments through their lending and funding activities. The Board thus concluded on July 12, 1991, the activity of trading for a company's own account in derivative instruments based on bank-eligible securities and certain money market instruments to be closely related to banking (see 1991 FRB 759).

#### 3260.0.3.2 Dealing as a Registered Options Trader on Foreign-Exchange Options

A foreign bank subject to the BHC Act applied under section 4(c)(8) of the act to deal, through its wholly owned U.S. subsidiary, as a registered options trader (trader) on foreign-exchange options. As a trader, the subsidiary would act as dealer and market maker in such options to assist in the maintenance of a “fair and orderly” market on the designated exchange. A trader deals for its own account in order to maintain a “fair and orderly” market in certain options when a lack of price continuity or temporary disparity exists on options for which the trader

makes a market. The subsidiary would be obliged to make a market in the proposed foreign-currency options, or bid and offer, for all traders who approach it on the designated exchange. The subsidiary would not be obliged in any way as to the price and quantity it bids and offers. A trader is permitted to “leave the floor,” that is, not trade, if it meets minimum trading levels each quarter.

The Board previously recognized that foreign-exchange activities have traditionally been conducted at banks and are permissible activities under the BHC Act.<sup>7</sup> The Board noted that the Office of the Comptroller of the Currency authorized national banks to deal in foreign-currency options as a trader on a securities exchange. It also noted that through bank participation in the interbank market for foreign-currency options, banks developed experience in dealing, market making, and risk management, which are deemed essential elements of the activities proposed. For these reasons and the facts presented in the BHC’s application, the Board approved the non-banking activity as being closely related to banking. The application was approved by the Board on July 30, 1990 (1990 FRB 776).

### 3260.0.3.3 Acting as a Specialist in Options on Foreign Exchange

A foreign bank subject to the BHC Act applied for the Board’s approval under section 4(c)(8) of the act (12 U.S.C. 1843(c)(8)) and section 225.21(a) of the Board’s Regulation Y (12 C.F.R. 225.21(a)) for its wholly owned subsidiary (the company) to act as the sole specialist in deutsche mark options on a specified exchange (the exchange). As a specialist, the subsidiary would act as a dealer and market maker in these options for the purpose of assisting in the maintenance of a fair and orderly market on the exchange.

The Board found the activity of engaging as a specialist in foreign-currency options on the exchange to be closely related to banking for purposes of section 4(c)(8) of the BHC Act. Banks provide services that are operationally similar to the activities proposed. The Board deemed banking organizations to be particularly well equipped to provide the proposed activities. The Board believes that banks possess substantial experience in dealing in foreign exchange and related services that are similar to the functions involved in the BHC’s proposed specialist activity. Foreign-exchange activities were noted

as having been traditionally conducted by banks which are major participants in all aspects of the foreign-exchange markets. Banks act as market makers in various currencies. Banks trade for their own account as well as for their customers in virtually all foreign-exchange markets and instruments, including trading in foreign-currency options on regulated exchanges, as proposed by this BHC applicant.

The Board believes the financial risk in this case to be sufficiently minimized since (1) the rules of the exchange allow the specialist to set the price and quantity that it will buy and sell in order to limit its risk in an adverse or volatile market; (2) the specialist is prohibited from speculating; and (3) the BHC has committed not to write unhedged options, having developed substantial experience with hedging from its existing foreign-currency and options business. The company will be a registered broker-dealer with the Securities and Exchange Commission (SEC) and will thus be subject to the SEC’s net capital rule. The Board expects that the company will maintain capital adequate to support its activity and to cover reasonable expenses and losses at all times.

The Board considered its earlier decision (1986 FRB 141) to deny a proposal to act as a specialist in French franc options on the exchange, summarized in section 3700.8. The Board believes that the facts and circumstances in this case were different in several significant respects from the current situation. The current proposal did not raise the issues relating to potential conflicts of interest and risk raised by the earlier decision (1986 FRB 141). The markets for deutsche marks and deutsche mark options are more liquid than they were for French francs at that time. Further, the market for foreign-currency options has broadened significantly on the exchange and the involvement of commercial banks in that market has become more widespread. The Board approved the BHC’s application by order on June 22, 1989 (see 1989 FRB 580).

### 3260.0.3.4 Acting as a Dealer, Broker with Respect to Interest-Rate and Currency Swaps and Related Transactions

A bank holding company applied pursuant to section 4(c)(8) of the BHC Act and section 225.23(a) of the Board’s Regulation Y for its wholly owned subsidiary to engage de novo in—

7. See 1989 FRB 217, 308, and 580.

1. intermediating in the international swap markets by acting as originator and principal in interest-rate swap and currency-swap transactions;
2. acting as an originator and principal with respect to certain risk-management products such as caps, floors, and collars, as well as options on swaps, caps, floors, and collars (“swap-derivative products”);
3. acting as a broker or agent with respect to the foregoing transactions and instruments; and
4. acting as an advisor to institutional customers regarding financial strategies involving interest-rate and currency swaps and swap-derivative products.

The Board has permitted bank holding companies under section 4(c)(8) of the act to provide advice in connection with interest-rate and currency swaps, interest-rate caps, and similar transactions (see 1987 FRB 59 and 1989 FRB 308).<sup>8</sup> However, the Board had not previously

approved the remaining activities proposed under section 4(c)(8) of the act. The Board determined that the remaining activities proposed are closely related to banking for the reasons summarized below.

*Intermediating in the International Swap Market; Acting as an Originator and Principal with Respect to Certain Risk-Management Products—Caps, Floors, Collars, and Options on Swaps, Caps, Floors, and Collars*

1. Banks, in particular, the money-center banks, do conduct the proposed intermediation activities within the international swap market.
2. Banks have participated in the swap markets for several years as end-users, entering into swaps and purchasing swap-derivative products in order to hedge other business risks or to match assets and liabilities.

*Acting as a Broker or Agent with Respect to These Transactions and Instruments*

1. Banks provide services that are operationally similar to the proposed activities.
2. The Board had previously determined that acting as a broker with respect to foreign-exchange forward transactions is closely related to banking since banks have historically engaged in the provision of assistance with respect to foreign exchange. (See 1983 FRB 221). Currency swaps are very similar to foreign-exchange forward transactions. The primary difference is the exchange of interest rates in connection with currency swaps. Interest-rate swaps are similar to currency swaps in that they involve agreements to exchange different payment streams that arise out of a prescribed principal amount. Similarly, caps, floors, and collars involve agreements to pay an amount by reference to a prescribed interest rate.

The Board approved the application on June 26, 1989 (see 1989 FRB 582), subject to the commitments included in the order to minimize the potential risk (that is, credit, price, basis, portfolio, and operations risk) and the possible conflicts of interest.

### 3260.0.3.5 Currency Swaps for Hedging the BHC’s Own Position in Foreign Currency

A foreign bank, subject to section 4 of the BHC Act, applied for the Board’s permission to acquire,

<sup>8</sup> Swap terminology:

*Interest-rate swap.* An exchange between two counterparties of different payment streams arising out of fixed-rate and floating-rate payment obligations. The exchange is made using the same currency and is calculated by reference to a mutually agreed-upon “notional” principal amount.

*Currency swap.* An exchange between two counterparties of a fixed-rate interest obligation in one currency for a fixed-rate interest obligation in another currency. Currency swaps may involve an initial physical exchange of principal at an agreed-upon current exchange rate or an exchange of interest payments in different currencies on an agreed-upon notional amount with no actual transfer of principal. In either case, there will be periodic exchange of fixed-rate interest payments over the course of the swap. Upon maturity, there would be a re-exchange of the original principal amounts.

*Cap.* An agreement under which one party purchases from the other a promise to pay, at predetermined future times, the excess, if any, of a specified floating interest rate over a fixed per annum rate. Caps may be sold separately or packaged with an interest-rate swap.

*Floor.* An agreement under which one party purchases a promise by another to pay the amount, if any, by which a specified floating interest rate is lower than a fixed per annum rate at specified times during the life of the agreement. Floors may be sold separately or packaged with an interest-rate swap.

*Collar.* The simultaneous sale of a cap and purchase of a floor, or purchase of a cap and sale of a floor.

*Agent or broker in swap market.* An agent or broker in the swap market locates, for a fee, a suitable counterparty for a party seeking to enter into a swap agreement.

*Intermediary in swap market.* A party that is willing to step between the two parties of a swap agreement and act as a principal counterparty with each of the other participants, thus taking on the credit risk of each of the participants. Upon entering into a swap with one counterparty, the intermediary enters into an equivalent and offsetting swap with another counterparty.

through its wholly owned subsidiary, all the shares of a company located in New York, N.Y. The acquired company would engage in several nonbanking activities. One of the activities, not previously approved by the Board for BHCs, consisted of entering into currency-swap transactions for hedging the BHC's own position in foreign currency. The Board previously found that banks engage in this activity and thus concluded that the activity is closely related to banking.<sup>9</sup> In conducting this activity, the applicant is to use the same policies, quantitative limitations, and internal controls and audit programs applicable to its trading in futures, options, and options on futures and similar contracts used for hedging, including the guidelines in the Board's policy statement.<sup>10</sup> The application was approved on August 15, 1990 (1990 FRB 860).

### 3260.0.3.6 Dealing in Gold, Silver, Platinum, and Palladium Bullion and Coins

On September 27, 1973, the Board approved a foreign banking organization's request to acquire 30 percent of the voting shares of a domestic company engaged in the trading and arbitrage of gold and silver bullion on various exchanges and in the open market. The subsidiary is enabled to participate in the domestic gold bullion market under 12 U.S.C. 24 (para. 7), which specifically authorized national banks to deal in bullion.

The Board found that buying and selling gold and silver bullion and silver coin, dealing in exchange and silver futures, and arbitraging gold and silver in markets throughout the world are activities closely related to banking or managing or controlling banks. Thus, in approving the application, the Board maintained its basic position that it will benefit the public to allow foreign banks to engage in U.S. activities on a nondiscriminatory basis. (See 1973 FRB 775.)

In another case, a BHC applied for the Board's permission to engage in certain activities related to dealing in gold and silver bullion. The activities consisted of (1) buying and selling gold and silver bullion, bars, rounds, and bullion coins for its own account and the account of others; (2) financing the production, refining, and fabri-

cation of gold and silver, including lending and borrowing gold and silver in connection with such financing; (3) arbitraging gold and silver in markets throughout the world; and (4) providing various incidental services for customers, such as arranging for the safe custody, assaying, and shipment of gold and silver.<sup>11</sup>

The Board determined previously that many of the proposed activities are permissible for BHCs. A BHC may engage in the purchase and sale of gold and silver for its own account and for the account of others.<sup>12</sup> The Board believed the assaying and arranging for transport to be part of this activity.<sup>13</sup> Financing activities for the production and fabrication of gold and silver are permissible activities. (See section 225.28(b)(1) of Regulation Y—Extending credit and servicing loans.) The Board approved the application by order on November 24, 1986 (1987 FRB 61). (See SR-87-7.)

In a subsequent case, a foreign banking organization presented its application to the Board, pursuant to section 4(c)(8) of the BHC Act, requesting permission to engage in the activity, through its wholly owned subsidiary, of purchasing and selling platinum coins issued by the Canadian and Australian governments as legal tender. The subsidiary would acquire the platinum coins issued by the Canadian and Australian governments solely for the purpose of effecting distribution. It would maintain an inventory of the coins. However, it would not purchase the coins for investment or speculation for its own account or offer its customers investment advice regarding their purchase and sale. It would enter into forward contracts with its customers. In considering the BHC's application, the Board noted that the Office of the Comptroller of the Currency had authorized national banks to purchase and sell platinum coins and that the proposed activities were operationally and functionally similar to purchasing and sell-

11. The applicant further notified the Board of its intention to purchase and sell for its own account options, futures, and options on futures on gold and silver bullion. The applicant committed to take positions in these investments only as a means of hedging its position in the underlying commodity, that is, gold and silver. The activity was thus permissible under section 4(c)(1)(C) of the BHC Act, which allows BHCs to furnish services to or perform services for such BHCs or its banking subsidiaries.

12. See 1986 FRB 345, 1986 FRB 146, 1985 FRB 467, and 1981 FRB 635.

13. The Board allowed another BHC to provide storage facilities, weighing, coin-counting, and transportation services for bullion and coin. (See 38 *Federal Register* 27,552 (1973).)

9. See 1989 FRB 582.

10. Statement of Policy Concerning Bank Holding Companies Engaging in Futures, Forward and Options Contracts on U.S. Government and Agency Securities and Money Market Instruments. See 12 C.F.R. 225.142 (establishing guidelines for trading in forward, futures, and option contracts on financial instruments).

ing gold and silver coins. The Board found the purchasing and selling of platinum coins that function as legal tender to be closely related to banking. The related application was approved on June 25, 1990 (1990 FRB 681).

In a more recent case, a foreign bank subject to the provisions of the act applied for the Board's permission under section 4(c)(8) of the act and section 225.23 of Regulation Y for its section 20 subsidiary to trade platinum coin and bullion for its own account. The Office of the Comptroller of the Currency has determined that a national bank may engage in this activity. (See OCC Interpretive Letter No. 553, May 2, 1991, relying, in part, on the fact that several countries had recently introduced platinum coins.) The Board had not previously determined that this activity was closely related to banking under section 4(c)(8) of the act. As stated previously, it had determined that the purchase and sale of platinum coins that function as legal tender is an activity that is closely related to banking. (See 1994 FRB 346 and 1990 FRB 681.) The Board had also approved as a non-banking activity, under Regulation K, trading in platinum by bank holding company subsidiaries located abroad (1994 FRB 177 and 1990 FRB 552). On the basis of these decisions, the Board concluded that the proposed activity is closely related to banking. (See 1995 FRB 190.)

With respect to palladium, a bank holding company applied for the Board's approval under

section 4(c)(8) of the act and section 225.23 of the Board's Regulation Y (12 C.F.R. 225.23) to engage de novo through a wholly owned asset-management subsidiary that will be established to serve as the general partner of limited partnerships (the partnerships) for investing in a wide variety of commodities and exchange-traded and over-the-counter instruments, including trading in precious metals. The partnerships would trade and invest in coin and bullion consisting of such precious metals as palladium, platinum, gold, and silver.

The Board has previously determined that it is closely related to banking under the act for bank holding companies to trade in all the instruments and commodities it proposed for the partnerships, except palladium.<sup>14</sup> Banks currently are permitted to engage in palladium trading.<sup>15</sup> Therefore, the Board concluded that trading palladium coin and bullion is closely related to banking within the meaning of section 4(c)(8) of the act.

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14. See 12 C.F.R. 225.28(b)(6)(iv), 1987 FRB 61 (trading gold and silver bullion and coin), and 1995 FRB 190 (trading platinum coin and bullion for a BHC's own account).

15. See OCC Interpretive Letters Nos. 683 (1995) and 553 (1991).

Effective December 31, 1980, the Board amended section 225.28(b) of Regulation Y (12 C.F.R. 225.28(b)(2)(i)) to include the performance of real estate appraisals in the list of activities permissible for bank holding companies to engage in. The Board concluded that banks perform real estate appraisals either in connection with extensions of credit involving real estate lending or as a discrete activity. In addition, such an appraisal activity calls upon the necessary skills and resources often possessed by banking organizations. The Board thus determined that the activity of performing appraisals of real estate is closely related to banking and that its performance by bank holding companies will yield net benefits to the public.

In addition to authorizing the appraisals of real estate as a nonbanking activity, the Board has previously determined by order that the appraisal of certain types of personal property, both tangible and intangible, is closely related to banking (1985 FRB 118). Providing personal property appraisals was added to the list of permissible nonbanking activities in Regulation Y. It was combined with the already approved activity of providing real estate appraisals (12 C.F.R. 225.28(b)(2)(i)). The action was approved by the Board on October 31, 1986, effective December 15, 1986, without any conditions. In permitting bank holding companies to engage in the activity of providing valuations of companies, the Board noted that the commercial lending and trust departments of banks commonly make valuations of a broad range of tangible and intangible property, including the securities of closely held companies. Providing valuations of companies necessarily involves the appraisal of various types of intangible personal property, such as securities of closely held corporations, as well as any tangible personal property that a company might possess.

Banks currently engage in the appraisal of personal property through their trust departments. Trust departments value private business interests for their own trust accounts and other types of personal property in a customer's estate for probate and tax purposes. Banks engage in property appraisal activities in connection with secured lending activities and routinely appraise property which they take as collateral on loans, including perishable commodities, durable goods, computer software, crops, livestock, machinery, and equipment.

Banks also engage in appraisal activities in connection with their leasing activities. With regard to leasing, banks determine the residual

value of leased property, such as vehicles and equipment, in order to establish the terms of a lease. Some money-center banks have appraised aircraft and locomotives, in connection with their leasing or lending transactions. Finally, banks may become involved in personal property appraising when they appraise real property, since certain types of real property, such as factories or apartment buildings, contain fixtures or other personal property that must be evaluated separately to determine the value of the real property.

### 3270.0.1 SCOPE OF INSPECTION

As noted within the subsequent inspection procedures, a sampling of real estate and personal property appraisals is to be reviewed to determine whether the appraised value of the property is reasonable and the documentation supports the appraisal.

Regulatory appraisal standards for federally related transactions are discussed below and must be considered in determining the scope of the inspection. The types, components, and procedures that should be used in evaluating real estate appraisals are included in section 2231.0, which contains guidelines for use by bank holding companies and subsidiaries for real estate appraisal and evaluation programs. Personal property appraisal involves estimating or determining the value of property other than real property.

### 3270.0.2 APPRAISAL STANDARDS FOR FEDERALLY RELATED TRANSACTIONS

The Board approved, on June 27, 1990, Appraisal Standards for Federally Related Transactions<sup>1</sup> that represent amendments to Regulation H (12 C.F.R. 208) and Regulation Y (12 C.F.R. 225) that are designed to protect federal financial and public policy interests in real estate transactions requiring the services of an appraiser. The regulations are intended to supplement the Board's appraisal guidelines currently in effect. Section

1. "Federally related transaction" refers to any real estate-related financial transaction entered into on or after August 9, 1990, that (1) the Board or any regulated institution engages in or contracts for and (2) requires the services of an independent appraiser.

208.50 of Regulation H refers to the appraisal standards for federally related transactions entered into by state member banks. The appraisal standards for federally related transactions are found in subpart G, section 225 of Regulation Y. The amendments were the result of implementing provisions of title XI of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) regarding real estate appraisals. The Regulation Y amendments identify which transactions require an appraiser (section 225.63),<sup>2</sup> set forth minimum standards for performing appraisals (section 225.64), and distinguish those appraisals requiring the services of a state-certified appraiser from those requiring a state-licensed appraiser (section 225.63). The effective dates are August 9, 1990, for the appraisal standards and July 1, 1991, for the appraiser certification and licensing requirements. Other provisions address appraiser independence (section 225.65), professional association membership, and competency.

### 3270.0.3 APPRAISER'S QUALIFICATIONS

With respect to an institution's selection of appraisers, examiners need to consider the following:

1. The professional certification, license, or other recognition of the competence of the appraiser. For real estate appraisals, the appraiser must have the proper state certification or license required by section 225.63 of Regulation Y. Examiners should also consider the September 1992 Guidelines for Real Estate Appraisal and Evaluation Programs. For personal property appraisals, the appraiser's qualifications might be evidenced by certification from a nationally recognized personal property appraisal organization or they may be supported by license or other recognition of the competence of the appraiser.

<sup>2</sup> The Appraisal Standards for Federally Related Transactions that are found in Regulation Y were amended, effective December 28, 1998, to exclude from the Board's appraisal requirements transactions involving the underwriting of or dealing in mortgage-backed securities. The amendment permits bank holding company subsidiaries engaged in the underwriting of and dealing in securities (so-called section 20 subsidiaries) to underwrite and deal in mortgage-backed securities without demonstrating that the loans underlying the securities are supported by appraisals that meet the Board's appraisal requirements.

2. The reputation and standing of the specialist in the view of his peers and others familiar with the person's capability of performance.
3. The relationship, if any, of the appraiser to the bank holding company in order to determine independence and objectivity.
4. The appraiser's documented accomplishments (for example, the appraiser's personal "qualifications statement" or job history resume).
5. Whether the appraiser's experience and knowledge or expertise relates to the property appraised.
6. Whether the appraiser meets continuing education requirements for licensing or certification. Membership or the absence of membership in any particular appraisal organization should not be accepted as *prima facie* evidence of an appraiser's qualifications.

### 3270.0.4 KEY COMPONENTS OF A PERSONAL PROPERTY APPRAISAL REPORT

When reviewing personal property appraisals, the appraisal should describe the following:

1. the kind of value being determined, such as fair market value, liquidation value, replacement/reproduction value, etc.
2. the property being valued
3. the detailed procedures used to estimate the values, such as—
  - a. analysis of comparable sales,
  - b. estimation and analysis of income, and
  - c. the appraised values as of a specific date
4. the name of the individual who made the appraisal and who is responsible for its validity and objectivity (to the person receiving the appraisal, to third parties, and to the public)
5. the personal qualifications data of the appraiser

### 3270.0.5 APPRAISAL OF CONSTRUCTION AND CONSTRUCTION ANALYSIS SERVICES

The activity of providing construction analysis services, including appraisal of construction projects at various stages of development and disbursement of construction loan funds in accordance with the terms of the loan agreement, is included within the permissible activities of real estate appraising and loan servicing.

3270.0.6 INSPECTION OBJECTIVES

1. To determine what financial effect the activity has on the parent holding company and the bank subsidiaries.
2. To determine whether the company has formal written policies and procedures. For real estate appraisals, the policies and procedures should be consistent with the Guidelines for Real Estate Appraisal and evaluation programs in section 2231.0.
3. To determine if there is compliance with the appraisal standards for federally related transactions detailed in the Board's Regulations H and Y.
4. To determine whether the appraisals were performed on an independent basis.
5. To determine whether the individuals performing the appraisals are qualified and that the appraisals are reasonable.
6. To determine whether the appraisals are current, complete, and reasonably accurate.
7. To determine if real estate appraisals are performed by state-licensed or state-certified appraisers.

and determine if there are any factors or trends that could have an adverse impact on the parent holding company or the bank subsidiaries.

2. Review the company's policies and procedures to determine that the following are present:
  - a. Adequate minutes are prepared of the board and board committee meetings.
  - b. Professional liability insurance and blanket bond coverage, if appropriate, are in place and the coverage appears sufficient.
  - c. Only qualified individuals are authorized to perform appraisals.
3. Review a sampling of the real estate and personal property appraisals to determine how a value is derived and whether this value is adequately substantiated.
4. For the appraisals reviewed in procedure 3, determine the reason for each appraisal. If it is for the purpose of valuing collateral for a loan extended by or to a bank affiliate, does the value appear realistic in relation to the loan amount?
5. Check for compliance with section 106(b) of the 1970 Amendments of the BHC Act (prohibition against tie-in arrangements). (See section 3500.0.)

3270.0.7 INSPECTION PROCEDURES

1. Review the company's financial statements

3270.0.8 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

<i>Subject</i>	<i>Laws <sup>1</sup></i>	<i>Regulations <sup>2</sup></i>	<i>Interpretations <sup>3</sup></i>	<i>Orders</i>
Real estate appraisal activity approval		225.28(b)(2)(i)		1980FRB 962 and 984 1997FRB 275
Acquisition of a nonbanking subsidiary that performs valuations of companies and of large blocks of stock for a variety of purposes				1985FRB 118
Personal property appraisal activity approval		225.28(b)(2)(i)		1986FRB 833 1997FRB 275
Appraisal standards for federally related transactions		225 subpart G, 225.61– 225.67	4–053	1990FRB 639 1999 FRB 50

1. 12 U.S.C., unless specifically stated otherwise.

2. 12 C.F.R., unless specifically stated otherwise.

3. Federal Reserve Regulatory Service reference.

## Section 4(c)(8) of the BHC Act (Check-Guaranty and Check-Verification Services) Section 3320.0

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The activities of check-guaranty and check-verification services permit bank holding companies to authorize the acceptance by subscribing merchants of certain personal checks tendered by the merchant's customers in exchange for goods and services, and to purchase validly authorized checks from merchants in the event the checks are subsequently dishonored.

The Board determined, previously, that check-guaranty services were closely related to banking, and had approved applications by bank holding companies on a case-by-case basis to engage in the activity (1979 FRB 263 and 1981 FRB 740). See also 1999 FRB 582, 1996 FRB 348 (fraud-detection services), 1994 FRB 1107, and 1995 FRB 492 (ATM network services).

The Board noted the potential for unfair competition or conflicts of interest with respect to the authorization of checks not drawn on affiliated banks. To minimize this possibility, the Board has maintained a condition in Regulation Y, noted in previous orders, stating that the check guarantor cannot discriminate against checks drawn on unaffiliated banks.

### 3320.0.1 INSPECTION OBJECTIVES

1. To determine the extent of exposure to guaranteed bad-check losses.
2. To determine whether management is qualified and effective in controlling losses.
3. To determine whether administrative and operating procedures and check-guaranty and check-verification transactions are processed in accordance with established Board or Board committee authorization policies and procedures, including adequate internal control procedures.
4. To determine whether recordkeeping and data processing are adequate and current to avoid losses resulting from outdated or inaccurate information.

5. To determine whether any significant contingent liabilities exist.
6. To determine whether the financial condition of the nonbanking subsidiary will have an adverse influence on the financial condition of the consolidated corporation.

### 3320.0.2 INSPECTION PROCEDURES

1. Review financial statements to determine the financial condition of the company and past and current operating trends. Test the accuracy of those records against the financial statements for each material asset, liability, and equity account.
2. Review the minutes of the board of directors and executive committees and correspondence exchanged with the company's legal counsel.
3. Review authorization records for check-guaranty and check-verification services for adequacy to determine whether check clearance is verified and whether the company has an accurate record of its contingent liability for guaranteed checks.
4. Review collection records to determine whether follow-up procedures on purchased guaranteed bad checks are adequate and whether they evidence timely collection contacts and successful recoveries.
5. Determine whether collection-problem checks are turned over to attorneys or collection agencies for appropriate collective or legal action on a timely basis.
6. Review the company's history of bad-check losses and the current status of uncollected bad checks, and determine whether adequate reserves have been set aside for those losses.
7. Determine whether fee calculations and billing procedures ensure accuracy and propriety.

3320.0.3 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

<i>Subject</i>	<i>Laws</i> <sup>1</sup>	<i>Regulations</i> <sup>2</sup>	<i>Interpretations</i> <sup>3</sup>	<i>Orders</i>
Engage de novo through a new nonbank subsidiary in the activity of check verification				1979 FRB 263
Retail check-authorization and check-guaranty activities				1981 FRB 740 1999 FRB 582
Fraud-detection services				1996 FRB 348 (see footnote 15)
Amendment of Regulation Y adding check verification as a permissible activity		225.28(b)(2)(iii)		1986 FRB 833 1997 FRB 275

1. 12 U.S.C., unless specifically stated otherwise.

2. 12 C.F.R., unless specifically stated otherwise.

3. *Federal Reserve Regulatory Service* reference.

The Board authorized the addition of operating a collection agency to the list of approved activities. A collection-agency subsidiary seeks to collect payment on the overdue bills of debtors, charging the party submitting the claim a flat dollar amount or a specified percentage commission contingent on the amount collected. The Board determined that operating a collection agency is closely related to banking as banks engage in debt-collection activities for loans they originate and service, including overdue credit-card accounts.

The Board recognized the potential for unfair competition and conflicts of interest through the operation of a collection agency. Accordingly, the Board established the following conditions on operating a collection agency:

1. The collection agency shall not obtain the names of customers of competing collection agencies from an affiliated depository institution that maintains trust accounts for those agencies
2. The collection agency shall not provide preferential treatment to an affiliate or a customer of such affiliate seeking collection of an outstanding debt.

## 3330.0.1 INSPECTION OBJECTIVES

1. To determine whether the collection agency is obtaining the names of customers of competing collection agencies from an affiliated depository institution that maintains trust accounts for those agencies.
2. To determine whether the collection agency provides preferential treatment to an affiliate or a customer of such affiliate seeking collection of an outstanding debt.
3. To determine what effect the activity has on the parent company, its subsidiaries, and the overall consolidated organization, and whether the company or activity evidences a going concern.
4. To determine whether the company has formal written policies and operating and internal control procedures to successfully administer the activity.
5. To determine the extent of management expertise, experience, and involvement with the administration of the activity.
6. To determine the extent of compliance with laws, regulations, and interpretations associated with the activity, including the Fair Credit Reporting Act, Fair Debt Collection

Practices Act, and Right to Financial Privacy Act.

7. To determine whether the company administers formal training programs which include proper operating and compliance methods.
8. To determine whether any significant contingent liabilities exist and whether those liabilities resulted from the failure of the bank holding company or its nonbanking subsidiary to fulfill its responsibilities as an agent for its customers.

## 3330.0.2 INSPECTION PROCEDURES

1. Review financial statements to determine the financial condition of the company and past and current operating trends. Test the accuracy of the financial statements against the company's financial records and other supportive corroborating evidence.
2. Review the minutes of the board of directors and executive committees, and correspondence exchanged with the company's legal counsel with regard to possible contingency losses.
3. Review collection records for adequacy, and determine whether the amount of payments received is independently verified.
4. Review collection records—tickler files—to determine whether follow-up procedures on acquired accounts are adequate and whether they evidence timely collection contacts and successful recovery rates.
5. Determine whether appropriate legal action is used and authorized by customers on a timely basis.
6. Determine whether fee calculations and billing procedures ensure accuracy and propriety.
7. Review parent company and subsidiary administrative and operating policies, and determine whether the collection agency is prohibited from obtaining the names of customers of competing collection agencies from an affiliated depository institution that maintains trust accounts for those agencies.
8. Review customer lists and billings and any prioritized collection schedules, and determine whether the collection agency is providing any preferential treatment to an affiliate or a customer of such affiliate seeking collection of an outstanding debt.

3330.0.3 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

<i>Subject</i>	<i>Laws</i> <sup>1</sup>	<i>Regulations</i> <sup>2</sup>	<i>Interpretations</i> <sup>3</sup>	<i>Orders</i>
Amendment of Regulation Y adding collection-agency services as a permissible activity		225.28(b)(2)(iv)		1986 FRB 833 1997 FRB 275

1. 12 U.S.C., unless specifically stated otherwise.

2. 12 C.F.R., unless specifically stated otherwise.

3. Federal Reserve Regulatory Service reference.

A bank holding company that engages in the activity of operating a credit bureau gathers, stores, and disseminates factual information relating to the identity and paying habits of consumers. Credit bureaus then provide this information for a fee to credit grantors, such as retailers, banks, and finance companies, to enable the institutions to arrive at prudent credit-granting decisions. The Board concluded that the activity is closely related to banking as banks maintain credit files and analyze credit information as part of their consumer-lending function.

The Board recognized that possible adverse effects could result from a potential conflict of interest when a bank holding company performs credit bureau activities. For example, under the Fair Credit Reporting Act, a credit bureau is required to investigate the accuracy of any item of information disputed by a consumer (15 U.S.C. 1681(i)). A bank holding company credit bureau may not conduct an impartial investigation if the disputed information originates with an affiliate. The Board thus imposed the condition that a credit bureau could not provide preferential treatment to a customer of an affiliated financial institution.

Regulation Y allows bank holding companies to engage only in consumer-credit-reporting activities rather than credit-reporting activities concerning large commercial institutions.

### 3340.0.1 Inspection Objectives

1. To determine whether the activity is limited to only consumer-credit-reporting activities.
2. To determine whether the bank holding company gives preferential treatment to a customer of an affiliated financial institution.
3. To determine the adequacy of internal policies and operating and internal control procedures.
4. To determine whether any significant contingent liabilities exist which arose from the failure of the holding company and its nonbanking subsidiary to fulfill their responsibilities as an agent for their customers.
5. To determine whether appropriate steps have been taken to ensure compliance with the Fair Credit Reporting Act, Equal Credit Opportunity Act, and Right to Financial Privacy Act.

6. To determine whether adequate controls exist to prevent unauthorized access into any computerized credit bureau credit files to preserve the confidentiality of the information stored for customers' use.

### 3340.0.2 INSPECTION PROCEDURES

1. Review the company's financial statements for accuracy, and determine if there are any factors or trends that could have an adverse impact on the parent company or its banking or nonbanking subsidiaries.
2. Review recordkeeping practices, and determine whether such management information systems are adequate to service customers and limit the risk of loss resulting from weak recordkeeping activities.
3. Review customer logs or client lists, and determine whether the activity is limited to only consumer-credit-reporting activities.
4. Review the activity and billings for a customer of an affiliated financial institution, and compare those findings to the activities and billings of other customers. Determine whether the bank holding company is giving preferential treatment to a customer(s) of an affiliated financial institution.
5. Review the company's policies and operating and internal control procedures for the activity, and determine whether they have been documented and whether they are being tested for compliance as part of the company's internal/external audits.
6. Review correspondence with legal counsel, and determine whether any significant contingent liabilities exist due to the failure of the holding company and its nonbanking subsidiary to fulfill their responsibilities as an agent for their customers.
7. Determine whether internal control procedures and compliance audits test for compliance with the Fair Credit Reporting Act, Equal Credit Opportunity Act, and Right to Financial Privacy Act.
8. Determine what steps have been taken to prevent unauthorized access to any computerized credit bureau credit files to preserve the confidentiality of the information stored for customers' use.

3340.0.3 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

<i>Subject</i>	<i>Laws</i> <sup>1</sup>	<i>Regulations</i> <sup>2</sup>	<i>Interpretations</i> <sup>3</sup>	<i>Orders</i>
Denial of a BHC’s proposal to engage in providing credit ratings for large businesses				1985 FRB 118
Activity is closely related to banking and a permissible nonbanking activity for consumer-credit reporting only		225.28(b)(2)(v)		1986 FRB 833 1997 FRB 275

1. 12 U.S.C., unless specifically stated otherwise.

2. 12 C.F.R., unless specifically stated otherwise.

3. Federal Reserve Regulatory Service reference.

Section 106(b) of the Bank Holding Company Act Amendments of 1970 (12 U.S.C. 1972(b)) generally prohibits a bank from tying a product or service to another product or service offered by the bank or any of its affiliates. A prohibited tie-in can occur if a bank (1) varies the consideration for a product or service (the “tied product”) from the bank or any of its affiliates, or (2) requires the customer to purchase another product or service from the bank or any of its affiliates as a condition for providing a product or service to a customer.

The intent behind section 106(b) is to affirm the principles of fair competition by eliminating the use of tie-in arrangements that suppress competition. Section 106(b) is intended to prevent banks from using their market power over certain products (specifically credit) to gain an unfair competitive advantage in other products. The restrictions of section 106(b) on banks are broader than those of the antitrust laws, as no proof of economic power in the tying-product market or anticompetitive effects in the tied-product market are required for a violation to occur. Although banks, like their nonbank competitors, were already subject to general antitrust prohibitions on tying, section 106 was enacted because Congress concluded that special restrictions were necessary given the unique role of banks in the economy.

Although the 1970 legislation amended the Bank Holding Company Act, it is applicable to all commercial banks, whether or not they are subsidiaries of holding companies. The term “company” is not used in section 106(b) but in another part of the 1970 legislation. Therefore, it is not relevant to section 106.

### 3500.0.1 ANTI-TYING RESTRICTIONS AND OTHER PROVISIONS

Section 106 of the BHC Act Amendments has five restrictions that are applicable to banks. These restrictions apply only when the products are separately available for purchase. The first two restrictions prohibit conditions constituting traditional tie-in arrangements; restrictions three and four prohibit reciprocal-dealing arrangements, and the fifth, with certain exceptions, prohibits an exclusive-dealing arrangement. Exempted from these prohibited conditional transactions are practices known as “traditional banking practices.”

Specifically, section 106 prohibits a bank, in any manner, from fixing or varying the consider-

ation for extending credit, leasing or selling property of any kind, or furnishing any service on the condition or requirement that the customer—

1. obtain additional credit, property, or service from the bank, other than a loan, discount, deposit, or trust service (a “traditional bank product”);
2. obtain additional credit, property, or service from the bank’s parent holding company or the parent’s other subsidiaries;
3. provide additional credit, property, or service to the bank, other than those related to and usually provided in connection with a loan, discount, deposit, or trust service;
4. provide additional credit, property, or service to the bank’s parent holding company or any of the parent’s other subsidiaries; or
5. not obtain other credit, property, or service from the competitors of the bank, the bank’s parent holding company, or the parent’s other subsidiaries, except that the lending bank may impose conditions and requirements in a credit transaction to ensure the soundness of the credit.

#### 3500.0.1.1 Section 106 Statutory Exceptions

The statutory “traditional bank product exception” of section 106 permits a bank to tie a product to a traditional bank product (a loan, discount, deposit, or trust service) offered by that bank, but not by any affiliated bank or nonbank. For example, a bank could condition the use of its messenger service on a customer’s maintaining a deposit account at the bank. Although the statutory traditional bank product exception appears to have been effective in preserving traditional relationships between a customer and bank, the statutory exception is limited in an important way. It does not extend to transactions involving products offered by affiliates. Section 106(b) provides a second statutory exception that authorizes the Board to prescribe exceptions by regulation or order when it determines that an exception will not be contrary to the purposes of this section.

Before the 1997 implementation of the revisions to Regulation Y, the tie-in provisions of section 106(b) applied to bank holding compa-

nies and their nonbank subsidiaries as though they were banks. The nonbank provisions were applied under section 4(c)(8) of the Bank Holding Company Act. A bank holding company and any nonbank subsidiary were prohibited from tying their products or services either to other products or services offered by the same company or to products or services offered by any affiliate, including a bank affiliate. With the 1997 revisions, *the tie-in prohibitions were eliminated for bank holding companies and their nonbank subsidiaries, except when electronic benefit transfer services are provided.* Bank holding companies and their nonbank subsidiaries are still subject to anti-tying restrictions with respect to electronic benefit transfer services, as set forth in section 7(i)(11) of the Food Stamp Act of 1977 (7 U.S.C. 2016(i)(11)). (See the tie-in arrangements discussion in section 3070.0.7.4.)

Section 106 prohibits not only tying arrangements, but reciprocity arrangements. Reciprocity arrangements condition the availability of, or vary the consideration of, one product on a customer's providing of another product. The statutory prohibition on reciprocity arrangements contains an exception to preserve traditional banking relationships. The exception provides that a bank may condition the availability of a product or service on the customer's providing to the bank some product or service "related to and usually provided in connection with" a loan, discount, deposit, or trust service. Like the statutory traditional bank product exception to the tying prohibition, the reciprocity prohibition does not apply to interaffiliate transactions. The 1997 Regulation Y revision extends the statutory exception for traditional banking relationships to cover such interaffiliate transactions.

## 3500.0.2 ANTI-TYING REGULATORY EXCEPTIONS

### 3500.0.2.1 Traditional Bank Product Exception

The traditional bank product exception of Regulation Y (12 C.F.R. 225.7 (b)(1)) permits a bank to extend credit, lease or sell property, provide any service, or to fix or vary its consideration on the condition that a customer obtain a traditional bank product (that is, a loan, discount, deposit, or trust service) from an affiliate of the bank. Effective in April 1997, the traditional bank

product exception was extended to affiliates' transactions. Interaffiliate arrangements are exempt to the same extent as interbank arrangements.

Section 106 and the Board's regulation also allow—

1. a section 20 affiliate to tell a customer that it can only receive placement services (or a discount thereon) if it obtains a loan from an affiliated bank; and
2. a section 20 affiliate to tell a customer that it can only receive placement services (or a discount thereon) if it obtains a loan from a nonbank affiliate.

This regulatory exception is a limited extension of the traditional bank product exception provided in section 106 and is coextensive with the statutory exception.<sup>1</sup>

### 3500.0.2.2 Safe Harbor for Combined-Balance Discounts

A bank may vary the consideration for any product or package of products based on a customer's maintaining a combined minimum balance in certain products specified by the bank (eligible products) if—

1. the bank offers deposits, and all such deposits are eligible products; and
2. balances in deposits count at least as much as nondeposit products toward the minimum balance. (See Regulation Y, section 225.7 (b)(2).)

### 3500.0.2.3 Safe Harbor for Foreign Transactions

The Board has adopted a "safe harbor" from the anti-tying rules for transactions with corporate customers that are incorporated or otherwise organized and that have their principal place of business outside the United States. This safe harbor also applies to individuals who are citizens of a foreign country and are not resident in the United States. (See Regulation Y, section 225.7 (b)(3).) However, the safe harbor would

1. See Chairman Greenspan's August 23, 1994, letter to the Honorable John D. Dingell, Chairman, Committee on Energy and Commerce, U.S. House of Representatives. See AD-94-68, August 26, 1994, and the Board's issuance of anti-tying exceptions on December 15, 1994, and April 20, 1995.

not protect tying arrangements involving a customer that is a U.S.-incorporated division of a foreign country. Furthermore, the safe harbor would not shelter a transaction from other anti-trust laws if they were otherwise applicable.

### 3500.0.3 APPLICABILITY OF ANTI-TYING EXCEPTIONS TO ENTITIES OTHER THAN BANKS

The Board's anti-tying rules adopt a definition of "bank" that clarifies that any exemptions afforded to banks would generally be applicable to credit card and other limited-purpose institutions and to United States branches and agencies of foreign banks.

### 3500.0.4 TIE-IN ARRANGEMENTS RELATING TO NONBANK BANKS

The Competitive Equality Banking Act, effective August 10, 1987, made nonbank banks and their affiliates subject to the anti-tying provisions of section 106 of the BHC Act Amendments of 1970 and to the insider and preferential lending restrictions of section 22(h) of the Federal Reserve Act. Thus, the nonbank bank may not condition the granting of credit on the purchase of a product or service from the parent holding company, or vice versa.

### 3500.0.5 VOLUNTARY VERSUS INVOLUNTARY TIE-IN ARRANGEMENTS

Voluntary as well as involuntary tie-ins have been a matter of concern. The customer, hoping to enhance his or her chance for bank accommodations (especially during periods of tight money), voluntarily patronizes subsidiaries of the bank. Voluntary tie-ins are said to have "just as serious" an economic effect as coercive ones because competition would be lessened to the extent that the tied product is no longer bought entirely on its economic merit.

### 3500.0.6 INSPECTION OBJECTIVES

1. To determine whether the bank holding company has adequate policies and procedures to ensure the compliance of its subsidiary banks with section 106(b) of the BHC Act Amendments.

2. To evaluate transactions between a company organized as a direct subsidiary of a bank holding company and affiliated banks for their compliance with federal laws and regulations and related policy guidance.
3. To ascertain, to the extent possible, that neither voluntary nor involuntary overt tie-in arrangements are present in credits extended by any BHC subsidiary bank.

### 3500.0.7 INSPECTION PROCEDURES

The Federal Reserve, as part of its inspections of bank holding companies and their subsidiaries and its examinations of state member banks and their subsidiaries, has had a long-standing policy that examiners should evaluate compliance with section 106(b) and the prohibitions against tie-in arrangements. During the course of all holding company inspections, the examiners should follow the inspection instructions set forth below, focusing on a bank holding company's responsibility to oversee and safeguard against potentially illegal tie-in arrangements by its banking subsidiaries and affiliates. The examiner's review should focus on (1) the bank holding company's establishment and monitoring of the internal controls and procedures for each bank subsidiary or affiliate and on its monitoring of compliance with written policies and procedures pertaining to tie-in arrangements, (2) the training provided to management and staff who are responsible for monitoring banking subsidiaries and affiliates for compliance with anti-tying provisions, and (3) the extent to which the bank holding company oversees internal loan reviews of pertinent bank extensions of credit to borrowers whose credit facilities or services may be susceptible to improperly imposed tie-in arrangements in violation of section 106(b) or the Board's regulations.

At a minimum, during the course of all bank holding company inspections, examiners are to thoroughly evaluate the organization's monitoring and overseeing of compliance with section 106(b) and the Board's regulations by its banking subsidiaries and affiliates. Examiners should use the following inspection procedures and checklist below. In addition, before beginning an inspection of any banking organization, Reserve Bank staff should evaluate the activities of the target banking organization to determine

whether it presents an increased opportunity for a bank to illegally tie its services or credit facilities to other services or facilities. If it does, the current inspection procedures, plus the checklist, should be used to check for compliance with section 106(b) and the Board's anti-tying regulations.

Following are the inspection procedures for tie-in arrangements:

1. Review the BHC's internal controls that are intended to prevent illegal tie-ins by its banks and affiliates.
2. Review the holding company's program to monitor subsidiary banks and their affiliates' internal loan reviews. Such reviews should include the inspection of credit files for loan agreements and other documentation that place conditions or restrictions on borrowers that indicate a possible tie-in. The bank holding company should conduct or oversee internal loan reviews of files for insurance applications, particularly if an insurance subsidiary maintains a consistently high penetration rate on credits granted by bank affiliates, which could indicate the presence of voluntary or involuntary tie-in arrangements.
3. Ascertain whether the bank holding company has policies requiring the periodic review of servicing contracts between the bank and its affiliates as well as the substance of actual transactions to determine—
  - a. the capacity in which the bank and its tied affiliate is acting (for example, is it acting as principal on its own behalf or as an agent for the affiliate bank?);
  - b. the nature of all services provided; and
  - c. billing arrangements, frequency of billing, method of computation, and basis for such fees.
4. Review the bank holding company's policy statement on the prohibition of tie-in arrangements, the adequacy of training provided to employees, and whether management and its internal auditors have periodically confirmed that there is full compliance with such internal policy.
5. Report on the Examiner's Comments and Matters Requiring Special Board Attention page any significant comments on tie-ins reviewed. (Comments would also be appropriate if controls to prevent tie-ins had not been established.)

## 3500.0.8 INSPECTION CHECKLIST FOR COMPLIANCE WITH THE TIE-IN ARRANGEMENT PROHIBITIONS

Provided below is a checklist of questions that has been designed to ensure an examiner's adequate, complete evaluation of a banking organization's compliance with section 106(b) of the BHC Act Amendments and the Board's anti-tying regulations during the course of Federal Reserve inspections. The checklist generally addresses written policies and procedures in this area and training and internal audit programs.

### A. Written Policies and Procedures

1. Does the bank holding company have a holding-company-wide policy statement that—
  - a. states that certain tie-in arrangements are illegal and
  - b. provides specific examples of impermissible practices relevant to the product line?
2. Do the bank holding company's bank subsidiaries and affiliates have copies of the holding company's written policy statement referred to in question A.1, and has it been revised, as appropriate, to provide specific examples of impermissible practices relevant to the particular product line?
3. Is the policy statement reviewed and updated regularly to ensure that the examples accurately reflect the products and services offered by the holding company and its subsidiaries?
4. Does the policy statement contain procedures for employees to follow in the event questions arise concerning the application of the prohibitions against tie-ins?
5. If the bank holding company does not have the holding-company-wide policy statement referred to in question A.1 (and that meets the requirements in questions A.2, 3, and 4), does each of the holding company's banking subsidiaries and affiliates have its own policy statement that meets those requirements?

### B. Training

1. Do the bank holding company and its bank and nonbank subsidiaries have training programs to ensure that employees are aware of the prohibitions against illegal tie-in arrangements?

2. Is participation in a training program required of new employees?
3. Is an annual compliance-review program required for employees?
4. If the inspection involves a bank that is not part of a holding company structure, does the bank meet the requirements described in questions B.1 through 3?

### C. Audit Procedures

1. Do the bank holding company and its bank subsidiaries and affiliates have annual audit procedures in place to ensure compliance with the prohibitions on tie-in arrangements?
2. Do counsel or other competent experts review transactions in the appropriate areas of the bank holding company, its bank subsidiaries, and affiliates to ensure compliance with the prohibitions against tie-in arrangements?

# Sections 4(c)(9) and 2(h) of the BHC Act (Nonbanking Activities of Foreign Banking Organizations)      Section 3510.0

A foreign bank that operates in the United States through a branch, agency, or commercial lending company subsidiary, or that owns or controls a U.S. bank or bank holding company, must conform to the nonbanking restrictions of the BHC Act. These limits, set forth in section 4 of the BHC Act, permit a foreign bank with U.S. banking operations to engage in banking and managing or controlling banks and other subsidiaries authorized by the act (such as Edge corporations).

The BHC Act also provides exemptions that permit a foreign bank with U.S. banking operations to engage in certain nonbanking activities. As with domestic bank holding companies, pursuant to section 4(c)(8) a foreign bank may own shares of any company that the Board has determined to be so closely related to banking or managing or controlling banks as to be a proper incident thereto. A foreign bank may also qualify for additional exemptions pursuant to sections 4(c)(9) and 2(h) if the bank chiefly engages in banking activities worldwide. These latter exemptions apply only to foreign banking institutions and seek to limit the extraterritorial application of federal banking law while preserving national treatment with their domestic counterparts.

## 3510.0.1 REGULATION K

Regulation K implements the nonbanking restrictions by applying the limits to any foreign banking organization (FBO). An FBO is (1) any foreign bank that either operates a branch, agency, or commercial lending company subsidiary in the United States, or that controls a U.S. bank, and (2) any company that owns or controls a foreign bank described in (1). Refer to 12 C.F.R. 211.21(n) to apply these limits. Regulation K requires any FBO that engages in activities in the United States to conform those activities to the nonbanking restrictions by either limiting the activities or obtaining an exemption. Refer to 12 C.F.R. 211.23(f).

Regulation K also provides a multi-step test for determining when an FBO primarily engages in banking activities worldwide and therefore qualifies for the additional exemptions contained in sections 4(c)(9) and 2(h) of the BHC Act. This “qualifying foreign banking organization” (QFBO) test is met if, “disregarding [the FBO’s] U.S. banking business, more than half of [the FBO’s] worldwide business is banking; and more than half of its banking business

is outside the United States.” Refer to 12 C.F.R. 211.23(b).

Under the QFBO test, an FBO must satisfy at least two of the following criteria:

1. The banking assets held outside the United States must exceed total worldwide nonbanking assets;
2. Revenues derived from the business of banking outside the United States must exceed total revenues derived from its worldwide nonbanking business; or
3. Net income derived from the business of banking outside the United States must exceed total net income derived from its worldwide nonbanking business.

In addition, the FBO must meet at least two of the following criteria:

1. The banking assets held outside the United States must exceed the banking assets held in the United States;
2. Revenues derived from the business of banking outside the United States must exceed the revenues derived from the business of banking in the United States;
3. Net income derived from the business of banking outside the United States must exceed net income from the business of banking in the United States.

Regulation K provides rules on how to calculate the assets, revenues, and net income of the FBO and its foreign subsidiaries.<sup>1</sup> In calculating whether an FBO meets the criteria above, however, the FBO may not include assets, revenues, or net income derived directly or indirectly from a branch, agency, subsidiary bank, or other company that engages in a banking business in the United States, a U.S. territory, Puerto Rico, Guam, American Samoa, or the U.S. Virgin Islands.

Regulation K provides a broader definition of “banking” for use in the QFBO test. A QFBO may include assets, revenues, and income from any activity that a U.S. bank holding company may perform abroad pursuant to section 211.5(d) of Regulation K if the activity is conducted by the foreign bank itself or by a subsidiary of a

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1. A subsidiary is any company that either (1) has 25 percent or more of its voting shares directly or indirectly owned, controlled, or held with the power to vote by a company, including a foreign bank or a foreign banking organization, or (2) is otherwise controlled or capable of being controlled by a foreign bank or foreign banking organization. Refer to 12 C.F.R. 211.21(x).

foreign bank. Thus, for example, an FBO may treat certain insurance and securities activities as banking activities for determining QFBO status. Refer to 12 C.F.R. 211.23(c)(2) and 211.5(d). This broader definition of banking applies to the QFBO test only, however. It does not define the types of permissible banking activities that a QFBO may perform in the United States.

An FBO that does not qualify, or that ceased to qualify for two consecutive years (as reported in the Annual Report of Foreign Banking Organizations, form FR Y-7), is not eligible for the exemptions afforded by sections 2(h) and 4(c)(9) of the act. An FBO that does not qualify for these exemptions may only engage in activities in the United States that are permissible for a domestic bank holding company. An FBO that no longer qualifies under the QFBO test may seek a determination of continued eligibility from the Board. Otherwise, the FBO may only continue to engage in activities begun, or retain investments acquired, before the end of the first fiscal year in which it failed to qualify. Other activities or investments must cease or be divested within three months of the filing of the second FR Y-7, which demonstrates that the foreign bank no longer qualifies for the exemptions.

### 3510.0.2 NONBANKING EXEMPTIONS FROM THE BHC ACT FOR QFBOS UNDER SECTIONS 4(C)(9) AND 2(H)

Sections 2(h) and 4(c)(9) of the BHC Act are exemptive provisions that seek to limit the extraterritorial impact of federal banking law. While there is considerable overlap in these two sections (e.g., only a QFBO is eligible for both kinds of exemptions), they also have significant differences (e.g., section 2(h) only exempts certain types of activities, whereas section 4(c)(9) may also exempt specific activities or investments upon Board order).

#### 3510.0.2.1 Section 4(c)(9) of the BHC Act

Section 4(c)(9) of the BHC Act authorizes the Board to exempt the U.S. activities of a QFBO, through order or regulation, if the exemption “would not be substantially at variance with the

purposes of [the BHC Act] and would be in the public interest.” The Board has implemented this provision in Regulation K to permit a QFBO to engage directly or indirectly in any activity outside of the United States; hold the shares of any company that engages in activities in the United States that are “incidental” to foreign business; hold a *noncontrolling* interest in any chiefly foreign company that engages in any activity in the United States, if the foreign company derives more than half its assets and revenues from outside the United States; or own or control voting shares of any company acquired in good faith in a fiduciary capacity as permitted by section 4(c)(4) of the act. An FBO is *not* permitted to own more than 5 percent of the shares of a foreign company that directly or indirectly engages in underwriting, selling, or distributing securities to an extent not permitted bank holding companies. Refer to 12 C.F.R. 211.23(f)(1), (2), and (3).<sup>2</sup>

The provision that permits a QFBO to own shares of a foreign company that engages in incidental, international activities in the United States has been defined by interpretation. That is, an activity is “incidental” to a foreign company’s activities outside of the United States only if it is an activity that an Edge or agreement corporation may perform. Section 211.4 of Regulation K defines the permissible activities of an Edge or agreement corporation.<sup>3</sup> An application to the Federal Reserve is not required before a QFBO engages in an activity that is incidental to international business under this exemption.

A QFBO may also request a specific exemption from the BHC Act under section 4(c)(9) to

2. Specifically, Regulation K permits a QFBO to (1) engage in activities of any kind outside the United States; (2) engage directly in activities in the United States that are incidental to its activities outside the United States; (3) own or control voting shares of any company that is not engaged, directly or indirectly, in any activities in the United States other than those that are incidental to the international or foreign business of such company; and (4) own or control voting shares of any company in a fiduciary capacity under circumstances that would entitle such shareholding to an exemption under section 4(c)(4) of the BHC Act if the shares were held or acquired by a bank.

3. Generally, these activities must have an international nexus and may consist of receiving deposits from foreign governments and persons; receiving deposits from other persons under certain conditions; holding or investing liquid funds in certain forms or instruments; engaging in certain credit activities or borrowing funds; receiving or collecting payments under certain conditions; performing foreign exchange activities; acting as a fiduciary, investment advisor, or broker or performing other activities related to investing under certain conditions; providing banking services for employees; and engaging in other activities with prior Board approval. Refer to 12 C.F.R. 211.4(e).

perform otherwise impermissible activities in the United States. The Board grants these requests on a case-by-case basis.

### 3510.0.2.2 Section 2(h) of the BHC Act

Section 2(h) of the BHC Act permits a QFBO to own or control the voting shares of a foreign company that is principally engaged in business outside of the United States and either (1) has no U.S. activities or (2) engages directly or indirectly in activities in the United States that are the same or related to the company's principal business abroad.

Section 2(h) is designed to allow a QFBO that has foreign commercial or industrial affiliates to continue to hold those affiliates even if the affiliate engages in activities in the United States that would ordinarily be prohibited by section 4 of the BHC Act. The U.S. activities must be the same kind of activity the affiliate conducts outside the United States and the foreign affiliate must be chiefly foreign, that is, it must derive more than half of its assets and revenues from outside the United States. The U.S. branches and agencies of a QFBO may not lend to an affiliate held under section 2(h) except on an arms-length basis.

A QFBO may *not* engage in financial activities in the United States on the basis of section 2(h). Regulation K provides a list of activities that are considered "financial." These activities should be referenced to Division H of the Standard Industrial Classifications (SIC) as well as to selected activities in other divisions of the SIC that are considered financial in nature.

Section 2(h) is implemented in Regulation K as follows. A QFBO may—

"own or control voting shares of a foreign company that is engaged directly or indirectly in business in the United States other than that which is incidental to its international or foreign business, subject to the following limitations:

1. More than 50 percent of the foreign company's consolidated assets shall be located, and consolidated revenues derived from, outside the United States;

2. The foreign company shall not directly underwrite, sell, or distribute, nor directly own or control more than 5 percent of the voting shares of a company that underwrites, sells, or distributes, securities in the United States except to the extent permitted bank holding companies." Refer to 12 C.F.R. 211.23(f)(5)(ii).

Regulation K places additional restrictions on the 2(h) exemption when a QFBO owns a foreign company that is a subsidiary. Specifically, the "foreign company must be, or must control, an operating company, and its direct or indirect activities in the United States shall be subject to the following limitations:

1. The foreign company's activities in the United States shall be the same kind of activities or related to the activities engaged in directly or indirectly by the foreign company abroad as measured by the 'establishment' categories of the Standard Industrial Classification (SIC) (an activity in the United States shall be considered related to an activity outside the United States if it consists of supply, distribution, or sales in furtherance of the activity). Refer to 12 C.F.R. 211.23(f)(5)(iii)(A).

2. The foreign company may engage in activities in the United States that consist of banking securities, insurance or other financial operations, or types of activities permitted by regulation or order under section 4(c)(8) of the BHC Act only under regulations of the Board or with the prior approval of the Board.

- a. Activities within Division H (Finance, Insurance, and Real Estate) of the SIC shall be considered banking or financial operations for this purpose, with the exception of acting as operators of nonresidential buildings (SIC 6512); operators of apartment buildings (SIC 6513); operators of dwellings other than apartment buildings (SIC 6514); operators of residential mobile home sites (SIC 6515); and operating title abstract offices (SIC 6541); and

- b. The following activities shall be considered [under section 211.23(g) of Regulation K]<sup>4</sup> financial activities and may be engaged in only with the approval of the Board: credit reporting services (SIC 7323); computer and data processing services (SIC 7371 to 7379); armored car services (SIC 7381); management consulting (SIC 8732, 8741, 8742, and 8748); certain rental and leasing activities (SIC 4741, 7352, 7353, 7359, 7513, 7514, 7515, and 7519); accounting, auditing, and bookkeeping services (SIC 8721); courier services (SIC 4215 and 4513); and arrangement of passenger transportation (SIC 4724, 4725, and 4729)."

4. Section 211.23(g) of Regulation K permits a foreign banking organization to request a case-by-case exemption from the nonbanking restrictions to engage in otherwise impermissible activities pursuant to section 4(c)(9) of the BHC Act.

The latter restriction in paragraph 2 above reflects the fact that section 2(h) is not the source of authority for a QFBO to engage in banking, securities, or other financial activities in the United States through a subsidiary.

The section 2(h) exemption only applies to the nonfinancial, nonbanking activities of an FBO. To preserve competitive equity, the exemption does not permit an FBO to control a foreign nonbanking company that engages in, or that holds more than 5 percent of the voting shares of another company that engages in, banking, securities, insurance, real estate, or other financial activities in the United States. These activities may be performed only with Federal Reserve approval under section 4(c)(8) or 4(c)(9) of the act. Refer to 12 C.F.R. 211.23(f)(5).

3510.0.3 GRANDFATHER RIGHTS

Section 8 of the International Banking Act (IBA) provides grandfather rights to foreign banks that operated a branch, agency, or subsidiary com-

mmercial lending company at the time of enactment of the IBA.

Section 8(c) of the IBA permanently grandfathers activities engaged in directly or through an affiliate on or before July 26, 1978, or for which an application to engage in such activities had been filed on or before that date.<sup>5</sup> Grandfathered nonbanking activities may not be expanded through the acquisition of any interest in or the assets of a going concern engaged in the same activities. The Board may, subject to opportunity for hearing, terminate these grandfather rights where it is necessary to prevent undue concentration of resources, decreased or unfair competition, conflicts of interest, or unsound banking practices in the United States. A foreign bank that is required to terminate its indirect grandfathered activity may retain ownership of the shares of the grandfathered company for a period of two years from the date of the Board’s action.

5. The term “affiliate” means any company that controls, is controlled by, or is under common control with, the foreign bank or the parent of the foreign bank.

3510.0.4 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

<i>Subject</i>	<i>Laws <sup>1</sup></i>	<i>Regulations <sup>2</sup></i>	<i>Interpretations <sup>3</sup></i>	<i>Orders</i>
Foreign Banking Organizations	1841(h)  1843(c)(9) 3106	211.23(b)		

1. 12 U.S.C., unless specifically stated otherwise.

2. 12 C.F.R., unless specifically stated otherwise.

3. Federal Reserve Regulatory Service reference.

# Section 4(c)(10) of the BHC Act (Grandfather Exemption from Section 4 for BHC's Which Are Banks) Section 3520.0

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This section provides a “grandfather” exemption from the general prohibitions of section 4 for a small group of bank holding companies which are themselves banks. For such bank holding companies and their wholly-owned subsidiaries, the exemption provides for continued ownership of nonbank shares which were lawfully acquired and owned directly or indirectly prior to enactment of the Act (May 9, 1956). At the time of its enactment, this section accommodated only three bank holding companies.

It should be noted that this section, in refer-

ring to shares indirectly owned through subsidiaries, limits the exemption to “wholly-owned subsidiaries.” The reason for this limitation apparently ties to the Federal Reserve Act and other federal banking statutes which permit National and member banks to engage through wholly-owned operating subsidiaries in various bank-related activities.

It is required that the shares covered under this section have been continuously held since May 9, 1956. Such interpretation is in keeping with other sections of the Act.

## Section 4(c)(11) (Authorization for BHCs to Reorganize Share Ownership Held on the Basis of Any Section 4 Exemption) Section 3530.0

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Section 4(c)(11) was adopted to authorize bank holding companies to reorganize share ownership held on the basis of any section 4 exemption. Reorganization is permitted with respect to section 4(a)(2) grandfathered activities engaged in prior to June 30, 1968, retaining indefinite grandfather authority. Shares held pursuant to Board approval under section 4(c)(8) or any other section 4 exemption also come within section 4(c)(11)'s reorganization authority.

Under section 4(c)(11), a bank holding company is authorized to reorganize its share ownerships, shift its activities among its various entities and form new subsidiaries without Board approval as long as there is no change in the activities of the bank holding company system. Congress also felt it entirely appropriate for

these companies to expand their activities so long as such expansion did not produce anti-competitive or other adverse effects. Accordingly, internal expansion of the grandfathered activities was permitted but the provision was added that this section does not authorize the grandfathered companies to acquire, either directly or indirectly, any interest in or the assets of any going concern outside the holding company system (unless the acquisition is pursuant to a contract entered into before June 30, 1968). Congress reasoned that purchasing a going concern engaged in the grandfathered activities of a holding company would tend to have an anti-competitive effect in that it would reduce the number of firms competing against each other in a given activity.

Section 4(c)(12) of the BHC Act (Ten Year Exemption from Section 4 of the BHC Act)

Section 3540.0

This section provided an exemption from the general prohibitions of section 4 for shares held or activities which became subject to the Act by the 1970 amendments.

Section 4(c)(12) provided not only for continued ownership of shares or performance of activities so held or performed as of December 31, 1970, but also for others permitted afterward by the Board. As stated in subparagraphs (A) and (B) of section 4(c)(12), the 10-year exemption applied if such bank holding companies: (A)(i) ceased to be bank holding companies by December 31, 1980; or (A)(ii) ceased to retain direct or indirect ownership of the nonbank shares or engage in the nonbank activities by December 31, 1980; or (B) complied with such other condition as the Board may prescribe.

A company was required to file an irrevocable declaration that it would cease to be a bank holding company by January 1, 1981, unless the Board granted it hardship exemption under sec-

tion 4(d) of the Act. Such a company could then expand its nonbanking activities *de novo* without notification to the Board and could acquire a going concern nonbank company 45 days after informing the appropriate Reserve Bank of the proposed acquisition unless notified otherwise within that time. If an irrevocable declaration was not filed, then no acquisition could have been made or activities commenced under section 4(c)(12) except with prior Board approval. These limitations did not apply to acquisitions made pursuant to a binding commitment entered into before March 23, 1971.

Few bank holding companies have claimed an exemption under section 4(c)(12). It is unlikely that many situations involving section 4(c)(12) will be encountered by inspection personnel. However, if a 4(c)(12) company has committed to cease the nonbanking activities examiners must ensure that the divestiture has occurred.

3540.0.1 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

<i>Subject</i>	<i>Laws</i> <sup>1</sup>	<i>Regulations</i> <sup>2</sup>	<i>Interpretations</i> <sup>3</sup>	<i>Orders</i>
Divestitures		225.138		
Successor rights				1977 FRB 946

1. 12 U.S.C., unless specifically stated otherwise.  
2. 12 C.F.R., unless specifically stated otherwise.

3. Federal Reserve Regulatory Service reference.

Section 4(c)(13) of the Act governs the international activities of bank holding companies. In general, the Act authorizes the Board to permit domestic bank holding companies to invest in companies that do no business in the U.S. except what is incidental to international or foreign business. Bank holding companies may invest in the same companies as those in which Edge Corporations may invest, as set forth in section 211.5(d) of Regulation K.

In general, the Board has limited the types of activities in which a bank holding company may engage through the ownership of foreign companies to banking or financially related activities. These include all of the activities permitted under section 211.5(d) of Regulation K and section 4(c)(8) of the BHC Act including equity securities underwriting and management consulting. Also, many of the activities permitted abroad are not subject to the same limits as imposed domestically under 4(c)(8) (e.g., brokerage of all types of insurance is permitted abroad). If the investor engages only in these activities:

1. Initial investments may be made of \$25 million or 5 percent of the investor's Tier 1 capital in the case of a member bank, bank holding company, or Edge corporation engaged in banking, or 25 percent of the investor's Tier 1 capital in the case of an Edge corporation not engaged in banking.

2. Some additional investments may be made in any calendar year without prior notification or specific Board approval so long as:

- a. the total amount invested in that calendar year does not exceed 10 percent of the investor's Tier 1 capital; and

- b. the total amount invested under section 211.5(d) (including investments made pursuant to specific consent or prior notice) in that calendar year does not exceed cash dividends reinvested under paragraph 211.5(c)(1)(iii) plus 10 percent of the investor's direct and indirect historical cost in the organization. This investment authority, to the extent unexercised, may be carried forward and accumulated for up to five consecutive years. Also, any additional investment may be made in an organization in an amount equal to the cash dividends received from that organization during the preceding 12 calendar months or any investment may be made that is acquired from an affiliate at net asset value.

Larger investments, and applications to engage in activities not listed in 211.5(d), require adher-

ence to procedures outlined in section 211.5(c)(2) of Regulation K. In the case of an acquisition of a going concern, existing activities that would not otherwise be permissible for a subsidiary under section 211.5(d) cannot account for more than 5 percent of either the consolidated assets or the revenues of the acquiree.

An investor may invest directly or indirectly in a joint venture provided that, unless permitted by the Board, not more than 10 percent of the joint venturer's consolidated assets or revenues are attributable to activities that are *not listed* in 211.5(d) of Regulation K. An investor and its affiliates may make, directly and indirectly, portfolio investments in organizations engaged in activities not permissible for joint ventures, provided that:

1. The investments do not exceed 40 percent of the total equity of the organization, when combined with shares held in the organization that are held in trading or dealing accounts [under paragraph 211.5(d)(14) of Regulation K] or shares held in the organization under any other authority;

2. The investments do not exceed:

- a. 25 percent of the investor's Tier 1 capital where the investor is a bank holding company; or

- b. 100 percent of Tier 1 capital for any other investor, when combined with underwriting commitments and shares held in trading or dealing accounts under 211.5(d)(14) of Regulation K.

A member bank's direct investments are limited to:

1. Foreign banks;

2. Foreign organizations formed for the sole purpose of either holding shares of a foreign bank or performing nominee, fiduciary, or other banking services incidental to the activities of a foreign branch or foreign bank affiliate of the member bank; and;

3. Subsidiaries established pursuant to section 211.3(b)(9) of Regulation K.

The procedures involved in examining foreign subsidiaries of domestic bank holding companies are generally the same as those used in examining domestic subsidiaries engaged in similar activities. The on-site examination of such subsidiaries is, however, necessarily limited. In most cases, examiners should try to implement asset appraisal procedures by using records at the location of the U.S. parent or bank. Overseas

examinations are intended primarily to appraise the firm’s internal control systems and the sufficiency of the firm’s reporting to its parent company. For examination objectives and procedures for these subsidiaries, see instructions for similar section 4(c)(8) investments in this manual.

3550.0.1 INVESTMENTS BY BANK HOLDING COMPANIES, EDGE CORPORATIONS, AND MEMBER BANKS IN FOREIGN COMPANIES

Subject to the limitations within Subpart A of Part 211.5 of Regulation K (12 C.F.R. 211), the Board allows, with its specific consent, banking organizations to acquire and hold investments in foreign companies that do business in the United States subject to the following conditions:

1. The activities abroad, whether conducted directly or indirectly, must be confined to activities of a banking or financial nature and those that are necessary to carry out such activities. When engaging in those activities, the investors are to act in accordance with high standards of banking and financial prudence, having due regard for diversification of risks, suitable liquidity, and adequacy of capital; and
2. The activities are either those that the Board has determined to be usual in connection with the transaction of banking or other financial operations abroad as listed in section 211.5(d) of Regulation K, including those activities authorized with the Board’s specific approval and have been determined to be usual in connection with the transaction of the business of banking or other financial operations abroad consistent with the FRA or the BHC Act;

3550.0.2 LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

<i>Subject</i>	<i>Laws <sup>1</sup></i>	<i>Regulations <sup>2</sup></i>	<i>Interpretations <sup>3</sup></i>	<i>Orders</i>
Investment and activities abroad		211		
Utilization of foreign subsidiaries to sell long-term debt obligations in foreign markets			3–706	
Investment by U.S. Banking Organizations in Foreign Companies that transact business in the U.S.		211.602		
Investment by U.S. banking organizations in Futures Commission Merchant activities overseas				1982 FRB 671
Investment by U.S. banking organization in general life insurance underwriting overseas				1984 FRB 168 1985 FRB 269
Investment in U.S. banking organization in property and casualty insurance underwriting overseas				1985 FRB 267 1985 FRB 808

<i>Subject</i>	<i>Laws</i> <sup>1</sup>	<i>Regulations</i> <sup>2</sup>	<i>Interpretations</i> <sup>3</sup>	<i>Orders</i>
Investment in U.S. banking organization in physical commodities brokered overseas				1981 FRB 369
Investment in Edge Act corporation	611–632			
Investment in foreign banking corporation	601–604/ 611–618			
Bank holding company subsidiaries, member banks, and Edge and Agreement corporations acting as agent outside of the U.S. in swap transactions. Subject to the limitation of Regulation H for State member banks		211.603 208.128		

1. 12 U.S.C., unless specifically stated otherwise.

2. 12 C.F.R., unless specifically stated otherwise.

3. Federal Reserve Regulatory Service reference.

In 1982 the Bank Holding Company Act of 1956 was amended by the Bank Export Services Act (BESA). The Bank Export Services Act provided an exemption to the prohibitions of Section 4 of the BHC Act for a bank holding company's investment in the shares of any company that is an export trading company. The (BESA) was designed to increase U.S. exports by encouraging investments and participation in export trading companies by bank holding companies and the specified investors.

An export trading company is a company that is exclusively engaged in activities related to international trade and, by engaging in one or more export trade services:

1. derives at least one-third of its revenues in each consecutive four-year period (excluding a two-year start up period) from the export of goods and services produced in the United States by persons other than the export trading company or its subsidiaries; and
2. derives revenues from the export, or facilitating the export, of goods or services produced in the United States and those revenues exceed revenues from the import, or facilitating the import into the United States, of goods or services produced outside the United States.

A bank holding company's direct and indirect investment in export trading companies may not exceed 5 percent of the bank holding company's consolidated capital and surplus. The total amount of extensions of credit by a bank holding company and its subsidiaries to its affiliated export trading company may not exceed 10 percent of the bank holding company's consolidated capital and surplus.

A bank holding company may not invest in an export trading company, unless the Board has been given sixty days prior written notice of the proposed investment. The Board may disapprove any proposed investment only if:

1. Such disapproval is necessary to prevent unsafe or unsound banking practices, undue concentration of resources, decreased or unfair competition, or conflicts of interest; or
2. It finds that such investment would affect the financial or managerial resources of a bank holding company to an extent that is likely to have a materially adverse effect on the safety and soundness of any subsidiary bank of such bank holding company; or
3. The bank holding company fails to furnish the information required by the Board.

An Edge Act or agreement corporation that is a subsidiary of a bank holding company may invest directly or indirectly in the aggregate up

to 5 percent (25 percent in the case of a corporation not engaged in banking) of the voting stock or other evidences of ownership in one or more export trading companies.

Sections 23A and 23B of the Federal Reserve Act applies to transactions between an export trading company and its affiliated banks. Regulation K, however, grants relief from section 23A's collateral requirements where a bank issues a letter of credit or advances funds to an affiliated export trading company solely to finance the purchase of goods for which: (1) the export trading company has a bona fide contract for the subsequent sale of the goods; and (2) the bank has a security interest in the goods or in the proceeds from their sale at least equal in value to the letter of credit or the advance. All other "covered transactions" between a bank and an affiliated export trading company should conform to sections 23A and 23B of the Federal Reserve Act.

### 3560.0.1 INSPECTION PROCEDURES

Export Trading Companies are generally subsidiaries of bank holding companies. Regulations applicable to them are contained in Section 211.31-4 of Regulation K. Inspections of Export Trading Companies will usually be conducted by international examiners or examiners having specialized training. Examiners conducting inspections of Export Trading Companies should be familiar with these sections as well as Section 4(c)(14) of the BHC Act.

There is no standardized inspection report form for inspections of Export Trading Companies. However, as a minimum, the report is to include the following items:

<i>Page</i>	<i>Description</i>
—	Cover Name of organization Location Name of parent Location of parent Date inspection commenced Date of financial statements
i	Table of Contents Same information as cover
1	Examiner’s comments Scope of inspection Summary of condition Violations Operating results Adequacy of accounting records, internal controls, and audit
2	Comparative balance sheets
3	Comparative income statements
4	Classified Assets  CONFIDENTIAL
A	Officers <sup>1</sup>
B	Directors <sup>1</sup>
C	Confidential comments Assessment of management

Inspection procedures should follow the Export Trading Company Questionnaire, illustrated herein. The questionnaire will be part of a special inspection report, prepared separately, or in conjunction with, a holding company inspection.

A copy of the Export Trading Company report as well as a copy of the Export Trading Company Questionnaire will be retained and included in the workpapers for the BHC inspection. Significant findings will be incorporated into the “Examiner’s Comments” page, or the Analysis of Financial Factors page, when appropriate.

1. Same information in tabular form as in Edge report.

3560.0.1.1 Export Trading Company Questionnaire

	Yes	No	NA	Comments
1. Is the Bank Holding Company (BHC) or banking Edge Corporation investment in the Export Trading Company (ETC) limited to 5% of its consolidated capital and surplus?  Reference: BESA, Section 203; BHC Act, Section 4(c); Regulation K, Section 211.33(a)		( )		
2. Is the investment in the ETC by an Edge Corporation not engaged in banking limited to 25% of its consolidated capital and surplus?  Reference: Same as question 1.		( )		
3. Did the BHC or Edge Corporation furnish the Federal Reserve Board through the local FRB written notice of its proposed investment in the ETC at least 60 days prior to its investment in the ETC?  Reference: BESA, Section 203; BHC Act, Section 4(c); Regulation K, Section 211.34		( )		
4. Do the direct and indirect outstanding credit extensions to the ETC by the investor and its subsidiaries exceed 10% of the investor's consolidated capital and surplus?  Reference: BESA, Section 203; BHC Act, Section 4(c)(14)(B); Regulation K, Section 211.33(b)		( )		
5. If the BHC or its subsidiary has extended credit to an affiliated ETC or to any of the ETC's customers:				
a. are the terms of the credit any more favorable than those afforded to similar borrowers in similar circumstances;		( )		
b. does the credit involve more than normal risk of repayment; and		( )		
c. does the credit present any unfavorable features?		( )		
Reference: Regulation K, Section 211.33(b)(2)				
6. If the BHC or its subsidiary has extended credit to another investor with at least 10% interest in the ETC, or to an affiliate of the investor:				
a. are the terms of the credit any more favorable than those afforded to similar borrowers in similar circumstances;		( )		

	<i>Yes</i>	<i>No</i>	<i>NA</i>	<i>Comments</i>
b. does the credit involve more than normal risk of repayment; and,	( )			
c. does the credit present any unfavorable features?	( )			
Reference: Same as question 5.				
7. Do covered transactions (under Sections 23A and 23B of the Federal Reserve Act) between a bank and an affiliated ETC meet the collateral requirements of Section 23A unless exempted because the bank has extended a letter of credit or advance to the affiliated ETC solely for the purchase of goods for which:		( )		
a. the ETC has a bona fide sales contract; and				
b. the bank has a security interest in the goods, or in the proceeds from their sale at least equal in value to the letter of credit or advance?				
Reference: Regulation K, Section 211.33(b)(3)				
8. Has the ETC received an export trade Certificate of Review which exempts it from antitrust laws?		( )		
Reference: BESA, Section 301				
9. Has the ETC Certificate holder submitted an annual report to the Secretary of Commerce as required?		( )		
Reference: BESA, Section 308				
10. Is the ETC exclusively engaged in activities related to international trade?		( )		
Reference: BESA, Section 203; BHC Act, Section 4(c)(14)(F) Regulation K, Section 211.32(a)				
11. Is the ETC operated principally for the purposes of exporting goods or services produced in the U.S., or for purposes of facilitating the exportation of goods or services produced in the U.S. by unaffiliated persons by providing one or more export trade services?		( )		

	Yes	No	NA	Comments
<p>The term “export trade services” includes, but is not limited to, consulting, international market research, advertising, marketing, insurance other than acting as principal, agent or broker in the sale of insurance on risks resident or located, or activities performed, in the United States, except for insurance covering transportation of cargo from any point of origin in the U.S. to point of origin in the U.S. to a point of final destination outside the U.S., product research and design, legal assistance, transportation, including trade documentation and freight forwarding, communication and processing of foreign orders to and for exporters and foreign purchasers, warehousing, foreign exchange, financing, and taking title to goods in order to facilitate U.S. exports. An ETC may engage in importing, barter, and third-party trades only if these activities further U.S. exports and only if the preponderance of ETC activities do not involve importing and the revenues from export activities exceed revenues from import activities.</p> <p>Reference: Same as question 10.</p>				
12. If the ETC has expanded its activities significantly beyond those in the original notice to the Board, such as to taking title to goods, product research and design, product modification, or activities not specifically covered in the BHC Act, has the investor given a 60 day notice in advance to the Board?			( )	
<p>Reference: Regulation K, Section 211.34</p>				
13. If the ETC has been in operation more than six years, is more than one-third of the ETC’s revenue in the last consecutive four-year period derived from exports or facilitating exports of U.S. goods and services produced in the U.S. by persons other than the ETC or its subsidiaries?			( )	
<p>Revenue includes net sales revenue from the trading of goods by the ETC for its own account and gross revenue from all other activities of the ETC.</p> <p>Reference: Regulation K, Section 211.32(a)</p>				

	<i>Yes</i>	<i>No</i>	<i>NA</i>	<i>Comments</i>
14. Does the ETC engage in agricultural production, manufacturing or product modification of goods, e.g., repackaging, reassembly, or extracting by-products other than incidental product modification as necessary to conform to the requirements of foreign countries for sale of the goods in the foreign countries?  Reference: BESA, Section 203; BHC Act, Section 4(c)(14)(c)  Reference: BESA, Section 203; BHC Act, Section 4(c)(14)(c)	( )			
15. Does the ETC take title to goods for which it has received no firm purchase order or commitment?  Reference: BESA, Section 103(a)(3)	( )			
16. What period of time do the goods on which the ETC has taken title remain in the inventory of the ETC?  Does this activity appear unduly speculative?  Reference: Same as question 15.	( )			
17. Do the nature and terms of sale of goods retained by the ETC appear to be in line with proper ETC business operations, i.e., not unduly speculative and related to authorized activities?  Reference: Same as question 15.	( )			
18. If the ETC acts as a principal, agent, or broker in the sale of insurance, does such activity exclude the sale of insurance on risks or activities located or performed in the U.S.  Reference: BESA, Section 203; BHC Act, Section 4(c)(14)(F)	( )			
19. If the ETC engages in, or holds shares of a company engaged in underwriting, selling or distributing securities in the U.S., are such activities limited to the same extent as for BHC's under applicable Federal and State banking laws and regulations?  Reference: BESA, Section 203; BHC Act, Section 4(c)(14)(C), 12 USC, Section 1843(c)(14)(C)(i)	( )			

	<i>Yes</i>	<i>No</i>	<i>NA</i>	<i>Comments</i>
20. Does the ETC take positions in commodities, commodity contracts, securities or foreign exchange other than as may be necessary in the course of the ETC's authorized business transactions?  Reference: BESA, Section 203; BHC Act, Section 4(c)(14)(D)	( )			
21. Are activities of the ETC Certificate holder in compliance with the Certificate of Review? (If not, the ETC could be subject to antitrust laws.)  Reference: BESA, Section 306		( )		
22. Does the ETC capital base appear to adequately support the strength of the ETC and its ability to withstand unexpected adverse developments so as not to affect the financial resources of the parent or the safety and soundness of affiliated banks?  Reference: 43 <i>Federal Register</i> , 26,448(1983).		( )		
23. Is there any evidence of adverse effect of the investment in the ETC on the investment in the ETC on the financial or managerial resources of the BHC or Edge Corporation investor, or on the safety and soundness of any subsidiary bank of a BHC investor?  Reference: BESA, Section 203; BHC Act, Section 4(c)(14)(A)(iv)(11)	( )			
24. Has the ETC's capital to asset ratio remained at all times at or above the minimum established in the original notice to the Board?		( )		
25. Is the ETC in compliance with operational policies, including maximum financial leverage per transaction, as established in the original notice to the Board?		( )		

( ) = Exception

\_\_\_\_\_  
Export Trading Company

\_\_\_\_\_  
Bank Holding Company Investor

\_\_\_\_\_  
Examination Date

Prepared by: \_\_\_\_\_

Date: \_\_\_\_\_